PART 1

# ACCOUNTING FOR REAL ESTATE TRANSACTIONS—GENERAL

CHAPTER 1

# ACQUISITION, DEVELOPMENT, AND CONSTRUCTION OF REAL ESTATE

## 1.1 OVERVIEW

Investments in real estate projects require significant amounts of capital. For real estate properties that are developed and constructed, rather than purchased, project costs include the costs of tangible assets, such as land and other hard costs (sometimes referred to as "bricks and mortar"); intangible assets and other soft costs, such as architectural planning and design; and interest and taxes. Costs are often incurred before the actual acquisition of the project, which raises certain questions—for example, from what point in time should costs be capitalized? What types of costs are capitalizable?

Determining what types of costs to capitalize in the preacquisition, acquisition, development, and construction stages of a real estate project has been an issue for many years. Several decades ago, the American Institute of Certified Public Accountants (AICPA) issued the following accounting guidance relating to cost capitalization, reacting to significant diversity in practice:

- Industry Accounting Guide, *Accounting for Retail Land Sales*, issued in 1973
- Statement of Position (SOP) 78-3, *Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects*, issued in 1978
- SOP 80-3, *Accounting for Real Estate Acquisition, Development, and Construction Costs*, issued in 1980

In 1982, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 67, *Accounting for Costs and Initial Operations of Real Estate Projects*, extracting the accounting principles provided by these AICPA pronouncements. Nevertheless, diversity in practice has continued to exist in some areas, including the capitalization of indirect costs during the development and construction period and the treatment of repair and major maintenance costs incurred subsequent to the completion of real estate projects.

The AICPA undertook another project to develop a comprehensive framework for cost capitalization and, in 2003, issued for public comment the proposed Statement of Position, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. That proposed SOP was approved by the AICPA Accounting Standards Executive Committee (AcSEC), in September 2003; however, a final SOP was never issued. In April 2004, the FASB decided not to clear that proposed SOP, mainly for the following stated reasons:

- Lack of convergence with International Accounting Standards
- The concept of componentization, particularly the amount of judgment allowed, which could potentially result in lack of comparability
- Implications for the capitalization of major overhaul expenses

## 1.2 ACQUISITION, DEVELOPMENT, AND CONSTRUCTION COSTS

FASB Statement No. 67 provides the primary authoritative guidance for the cost capitalization of real estate project costs. That Statement divides the costs incurred to acquire, develop, and construct a real estate project into preacquisition and project costs. Preacquisition costs encompass costs incurred in connection with, but prior to the acquisition of, real estate. Project costs include costs incurred at the time of the real estate acquisition, as well as costs incurred during the subsequent development and construction phase (see Exhibit 1.1).


**EXHIBIT 1.1** ILLUSTRATION OF COST CLASSIFICATION

Real estate developed by a company for use in its own operations other than for sale or rental is not within the scope of Statement 67.[1] Because—aside from the proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*—there is no authoritative literature relating to the capitalization of costs for properties used by an enterprise in its own operations, the guidelines in Statement 67 are generally also applied to properties used by an enterprise in its own operations.

1 FAS 67, paragraph 2(a)

**1.2.1 PREACQUISITION COSTS** Preacquisition costs are costs related to a real estate property that are incurred for the express purpose of, but prior to, obtaining that property.[2] They may include a variety of costs, such as:

- Payments to obtain an option
- Legal fees
- Architectural fees
- Other professional fees
- Costs of environmental studies
- Costs of feasibility studies
- Costs of appraisals
- Costs of surveys
- Planning and design costs
- Costs for zoning and traffic studies

### *1.2.1.1 Principles for the Capitalization of Preacquisition Costs*

OPTIONS TO ACQUIRE REAL PROPERTY

Payments for options to acquire real property are capitalized.[3]

PREACQUISITION COSTS OTHER THAN OPTIONS TO ACQUIRE REAL PROPERTY

Preacquisition costs other than the cost of options can only be capitalized if the acquisition of the property (or an option to acquire the property) is probable,[4] and if the costs meet the following two criteria:

- The costs must be directly identifiable with the property.
- The costs would be capitalized if the property were already acquired.[5]

FASB Statement No. 67 has established a high threshold for the capitalization of preacquisition costs with the requirement that the acquisition of real property be *probable*. If the purchaser is not actively seeking to acquire the real estate property or does not have the ability to finance or obtain financing for the property, or if there is an indication that the real estate property the purchaser seeks to acquire will not be available for sale, the project is not considered probable.[6] Any costs (other than costs relating to an option to acquire real estate) incurred before a project is considered probable have to be expensed as incurred. If the project becomes probable at a later point in time, costs incurred prior to the project becoming probable cannot subsequently be capitalized.

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2 FAS 67, Appendix A, paragraph 28

3 Land option deals may pose special accounting issues, as discussed in Section 1.7.3 of this chapter.

4 Footnote 3 of FASB Statement No. 67 states that "probable" in this context means "likely to occur," referring to the use of "probable" in FASB Statement No. 5. Paragraph 13 of the proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, uses that same threshold for the capitalization of preacquisition costs.

5 FAS 67, paragraph 4

6 FAS 67, paragraph 4(c)

**Example—Preacquisition Costs**

BetterStore Inc. (B) plans to build five storage centers in various cities throughout the United States. Ten suitable land parcels have been identified. The land parcels upon which B is considering building the storage centers are for sale, and B has the ability to obtain financing. The final decision as to which locations to use for the storage centers will be made after certain feasibility studies have been completed. To date, B has paid advisors $1 million for feasibility studies.

Can B capitalize the costs incurred for these feasibility studies?

No. Since B has not identified the specific locations for the storage centers, the costs incurred should be expensed.

Preacquisition costs that meet the requirements for capitalization outlined above are capitalized. Once the real estate property is acquired, any capitalized preacquisition costs are included in project costs. If, on the other hand, a company determines that the acquisition of the property is no longer probable, capitalized preacquisition costs are charged to expense to the extent they are not recoverable through the sale of plans, options, etc.[7]

The proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, states with respect to preacquisition costs when it becomes probable that the property will not be acquired:[8]

> If it becomes no longer probable that specific PP&E [property, plant, and equipment] will be acquired or constructed, previously capitalized preacquisition stage costs related to the specific PP&E should be reduced to the lower of cost or fair value. A rebuttable presumption exists that the fair value of the asset consisting of those preacquisition stage costs (excluding option costs) is zero (that is, the costs of the asset would be charged to expense), unless management, having the authority to approve the action, has committed to a plan to either (a) sell the asset and the proceeds can be reasonably estimated or (b) redeploy the asset in other specific PP&E of the entity and the redeployed asset meets the criteria for capitalization under the project stage framework in this SOP. If an entity subsequently acquires or constructs PP&E previously considered no longer probable to acquire or construct, preacquisition stage costs charged to expense under this paragraph should not be reversed.

AcSEC establishes a rebuttable presumption that the fair value of any capitalized preacquisition costs is zero once a project is abandoned, because the majority of the costs incurred in this stage would be "soft" costs that would generate only limited value for other projects.[9]

7 FAS 67, paragraph 5

8 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph 24

9 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph A29

***1.2.1.2 Capitalization of Internal Preacquisition Costs*** Activities in the preacquisition stage may be carried out by a company's in-house departments, which raises the question of (1) whether and (2) to what extent such internal preacquisition costs should be capitalized.

Emerging Issues Task Force (EITF) Issue No. 97-11, *Accounting for Costs Relating to Real Estate Property Acquisitions*, provides that internal preacquisition costs[10] are only capitalizable if the property is expected to be nonoperating at the date of acquisition. They are not capitalizable if the property is expected to be operating at the date of acquisition, such as internal preacquisition costs relating to the purchase of an existing shopping mall.[11]

A prerequisite for the capitalization of internal preacquisition costs is that they be directly identifiable with the specific property.[12] While "directly identifiable" is not further defined in Statement 67, the term has been interpreted narrowly in practice.

One may look to the proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, for implementation guidance:[13]

> . . . [d]irectly identifiable costs include only:
>
> a. Incremental direct costs of PP&E preacquisition activities incurred for the specific PP&E.
> b. Certain costs directly related to preacquisition activities performed by the entity (or by parties not independent of the entity) for the specific PP&E. Those costs include only payroll and payroll benefit–related costs (for example, costs of health insurance) of employees who devote time to a PP&E preacquisition stage activity, to the extent of time the employees spent directly on that activity and in proportion to the total hours employed.
> c. Payments to obtain an option . . . to acquire PP&E.

Notwithstanding the foregoing, an option to acquire property, plant, and equipment that meets the definition of a derivative instrument within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is accounted for following the guidance in Statement 133.[14]

Further, that proposed SOP states that costs of facilities, such as rent and depreciation, as well as general and administrative costs, should be expensed as incurred, as should all costs of executive management, corporate accounting,

10 EITF Issue No. 97-11 does not address the accounting for costs incurred for acquisitions of real estate properties that will be used in a company's own operations, other than for sale or rental.

11 EITF Issue No. 97-11

12 FAS 67, paragraph 4(a)

13 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph 19

14 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, footnote 4

acquisitions, office management and administration, marketing, human resources, and similar costs or functions.[15]

While that proposed SOP has never been issued in final form, the guidance provided by that proposed SOP nevertheless proves helpful when interpreting the provisions in Statement 67.

**1.2.2 PROJECT COSTS** Project costs are defined as "[c]osts clearly associated with the acquisition, development, and construction of a real estate project."[16] In certain real estate projects, land is developed and structures are being built or refurbished. In addition to the costs of acquiring land, development and construction costs are incurred to complete the project. Other real estate projects involve property acquisition only, such as the acquisition of shopping centers that are already in operation.

Paragraph 7 of Statement 67 states the general concept for the accounting for project costs:

> Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized as a cost of that project.

While this concept may appear straightforward, determining which costs are clearly associated with a real estate project can require significant judgment.

***1.2.2.1 Direct Costs*** Direct project costs are incremental costs that are directly related to the acquisition, development, and construction of the property. They may include the same types of costs as preacquisition costs, because certain activities can be performed before or after the acquisition. In addition to the types of costs listed in Section 1.2.1 of this chapter, project costs typically include:

- Purchase price[17]
- Commissions due to third parties
- Brokerage fees due to third parties
- Fees for title guarantee and title searches
- Recording fees
- Property taxes incurred during construction
- Insurance costs incurred during construction
- Costs of permits
- Engineering costs

15 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraphs 20 and 21

16 FAS 67, paragraph 28

17 Special issues may arise if seller and buyer of a real estate property enter into an arrangement, under which the seller agrees to lease (or lease up) the property. EITF Issue No. 85-27 addresses the accounting for such arrangements, which may, in substance, be adjustments to the purchase price of the property.

- Environmental remediation costs
- Demolition costs
- Construction costs (materials, labor)
- Costs of amenities[18]
- Donated land

All costs incurred need to be carefully evaluated to determine whether they qualify for capitalization. For example, the costs of real estate donated to governmental agencies that benefit a certain project are part of that project's costs.[19] However, if donated land does not benefit (and was not made in conjunction with) a real estate project, the costs should be expensed, rather than capitalized. Similarly, demolition costs incurred within a reasonable period after the acquisition of property are generally capitalized when they are incurred, if demolition is probable at the time of acquisition.[20] Industry practice is diverse with respect to the capitalization of demolition costs that are not incurred within a reasonable period after acquisition. The proposed SOP, if it had been issued in final form as proposed, would have required that demolition costs not incurred within a reasonable period of time after acquisition be expensed.[21] Questions also arise with respect to the capitalization of environmental remediation costs. While environmental remediation costs incurred within a reasonable period of time after the acquisition of property are generally capitalized as part of the project costs, determining whether environmental remediation costs incurred at a later point in time are capitalizable is more complex and involves significant judgment.[22]

***1.2.2.2 Indirect Costs*** Indirect project costs are capitalized to the extent they clearly relate to the acquisition, development, or construction of a real estate project. The following are examples of indirect internal project costs:

- Costs of planning department
- Costs of construction administration (for example, the costs associated with a field office at a project site)
- Internal costs incurred for cost accounting or project design[23]
- Depreciation of machinery and equipment used directly in construction[24]
- Payroll costs and employee benefits for employees working on the project

18 See Section 1.7.1 of this chapter.
19 FAS 67, paragraph 14
20 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph 34
21 Id.
22 See also Section 1.7.5 for further discussion regarding environmental remediation costs.
23 FAS 67, Appendix A, paragraph 28
24 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph 26

For internally incurred indirect costs to be capitalizable, a cost accounting system needs to be in place and adequate documentation needs to be maintained to support cost capitalization. For example, time may be recorded by the in-house designers to determine the percentage of their salaries to be allocated to a certain project. Indirect costs for which sufficient support cannot be provided, or that do not clearly relate to a project under development or construction, including general and administrative expenses, are expensed as incurred.[25]

Statement 67 does not provide any further guidance on how to determine what costs are clearly associated with the acquisition, development, and construction of a real estate project. As a result, considerable diversity in practice exists with respect to the types of indirect project costs that are capitalized.

The proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* limits the capitalization of indirect costs to:

- Costs that are directly identifiable with the specific property
- Costs incurred for property taxes and insurance for the portion of the property under construction[26]
- Demolition costs incurred in conjunction with the acquisition of PP&E, if demolition is probable at the time of acquisition and is expected to occur within a reasonable period after acquisition[27]

The proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* provides that the capitalization of directly identifiable indirect project costs should be limited to:

- Incremental direct costs of acquiring, constructing, or installing the property
- Payroll and payroll benefit–related costs of employees who devote time to the project
- Depreciation of machinery and equipment used in construction or installation
- The cost of inventory used in construction or installation[28]

The proposed SOP does not provide for the capitalization of other indirect costs, such as occupancy costs (including rent, depreciation, and other costs associated with facilities); these costs should be charged to expense as incurred.[29] While the proposed SOP may prove helpful in interpreting Statement 67, one has

25 FAS 67, paragraph 7

26 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 31

27 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 34

28 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 26

29 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 27

to keep in mind that the FASB has not cleared that proposed SOP, and therefore, it is low-level GAAP.

***1.2.2.3 General and Administrative Expenses*** FASB Statement No. 67 provides that "[i]ndirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses . . . be charged to expense as incurred"[30] without providing further guidance as to which expenses should be considered general and administrative expenses. The proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* is more specific: "All costs (including payroll and payroll benefit–related costs) of executive management, corporate accounting, acquisitions, office management and administration, marketing, human resources, and similar costs and functions should be charged to expense as incurred."[31]

***1.2.2.4 Property Taxes and Insurance*** Property taxes, insurance, and interest are commonly referred to as holding costs. Taxes and insurance are capitalized as part of the property's cost during the period in which activities necessary to get the property ready for its intended use are in progress.[32] The capitalization period for property taxes and insurance (beginning, end, and suspension) coincides with the capitalization period for interest set forth in FASB Statement No. 34, *Capitalization of Interest Cost,*[33] outlined in Section 1.2.2.5 of this chapter. After the real estate property is ready for its intended use, property taxes and insurance are charged to expense as incurred. Special considerations are necessary when development activities occur only on a portion of a real estate property. For example, a company may own a 50-acre parcel of land and is constructing a building on 5 of these 50 acres. The capitalization of property taxes and insurance would only be appropriate for interest and taxes relating to the five acres under construction.[34]

Insurance and taxes are capitalized during the construction period irrespective of whether the real estate is newly acquired or whether it has been used subsequent to its acquisition, with construction activities starting at a later point in time. For example, a hotel building may be redeveloped (refurbished) after it has been operating for many years. The proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* uses the "avoidable cost concept" to determine whether property taxes and insurance should be capitalized.[35] If the property has been used in the past as an operating asset,

30 FAS 67, paragraph 7

31 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 28

32 FAS 67, paragraph 6; depending on the real estate property: The term "ready for its intended use" encompasses both "ready for use" and "ready for sale." [FAS 34, paragraph 6, footnote 3]

33 FAS 67, paragraph 6, footnote 4

34 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph 31

35 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment,* paragraph A37

but is removed from operations for purposes of construction, property taxes and insurance are avoidable costs of construction, even though they are not incremental to the entity, since the entity could avoid the property taxes and insurance by choosing to dispose of the property. However, for properties under construction that remain in operation while construction takes place, the proposed SOP suggests that costs incurred for property taxes and insurance should be capitalized only if they are incremental and directly attributable to the construction activities.[36]

***1.2.2.5 Interest*** Undertaking real estate projects requires significant capital, and financing cost is a major cost factor. If real estate is acquired that is not ready for its intended use, interest expense incurred during the development and construction period is part of a project's costs that is capitalized.[37] FASB believes that through interest capitalization, a measure of acquisition cost is obtained that reflects the company's investment in the real estate asset.[38] Accordingly, interest capitalization is not discontinued when a real estate project is impaired; any write-down is increased by interest expected to be capitalized in future accounting periods.[39]

There may be a period of time in which a company generates interest income from the investment of unused funds on project financing obtained. Generally, such interest income is recognized as income when earned. It is not offset against interest cost when determining the amount of interest cost to be capitalized, except in the case of certain tax-exempt borrowings.[40]

The determination of the amount of interest to be capitalized in a real estate project is a four-step process:

**Step 1.** Determine whether the real estate project qualifies for interest capitalization.
**Step 2.** Determine the types of expenditures that qualify for interest capitalization.
**Step 3.** Determine the capitalization period.
**Step 4.** Determine the amount of interest cost to be capitalized.

#### Step 1. Determine Whether the Real Estate Project Qualifies for Interest Capitalization

The following assets qualify for interest capitalization:[41]

1. Assets that are constructed or otherwise produced for a company's own use
2. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects, such as real estate developments

36 Proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, paragraph 31
37 FAS 34, paragraph 6
38 FAS 34, paragraph 7
39 FAS 34, paragraph 19; FAS 144, paragraph 20
40 FAS 62, paragraph 3
41 FAS 34, paragraph 9

Additionally, investments in equity method investees may be qualifying assets, as explained in Section 1.7.6 of this chapter.

FASB Statement No. 34, *Capitalization of Interest Cost,* precludes interest capitalization for certain types of assets, including (1) assets that are in use or ready for their intended use, and (2) assets that, although not in use, are not undergoing activities to get them ready for their use.[42]

Land that is not undergoing activities necessary to get it ready for its intended use is not an asset qualifying for interest capitalization. Once activities are undertaken for the purpose of developing land for a particular use, the acquisition and development expenditures qualify for interest capitalization while those activities are in progress. If a structure is built on the land, such as a plant or an office building, interest capitalized on the land expenditures is part of the cost of the structure. If a tract of land is developed and subdivided to be sold as developed lots, interest capitalized on the land expenditures becomes part of the cost of the land.[43]

#### Step 2. Determine the Types of Expenditures That Qualify for Interest Capitalization

After it has been determined that a project qualifies for interest capitalization, the expenditures incurred for that project have to be evaluated to determine whether they qualify for interest capitalization. As a general rule, expenditures that do not require the transfer of cash or other assets or the incurrence of liabilities on which interest is accrued do not qualify for interest capitalization. As such, capitalized amounts financed through trade payables, retainages, or progress payment collections from customers may lead to differences between capitalized project costs and the amount of expenditures that qualify for interest capitalization. Paragraph 16 of FASB Statement No. 34 provides, however, that capitalized expenditures for an asset may be used as a reasonable approximation of expenditures on which interest is capitalized, unless the difference is material.

#### Step 3. Determine the Capitalization Period

Interest is capitalized when the following three conditions are present:[44]

- Expenditures for the asset (that qualify for interest capitalization) have been made.
- Activities that are necessary to get the asset ready for its intended use are in progress.
- Interest cost is being incurred.

The term "activities that are necessary to get the asset ready for its intended use" is interpreted broadly in practice. Such activities include administrative and

42 FAS 34, paragraph 10
43 FAS 34, paragraph 11
44 FAS 34, paragraph 17

technical activities before ground is broken, such as the development of plans or the process of obtaining permits from governmental authorities. If a company suspends substantially all activities related to the development of the property, the company has to evaluate the reason and duration of the suspension and determine whether interest capitalization during such period of suspension is appropriate. An interruption that is brief or inherent in the asset development process, such as labor strikes or weather conditions, would not lead to a cessation of interest capitalization, whereas a company-induced suspension in construction activities due to a decline in the real estate market would preclude interest capitalization.[45]

The capitalization period ends when the asset is substantially complete and ready for its intended use. By requiring that the capitalization period end when the asset is "substantially complete," the FASB intended to prohibit the continuation of interest capitalization in situations in which the final completion of assets is intentionally delayed. For example, a developer may choose to defer installing fixtures and fittings until condominium units are being sold to give buyers a choice of styles and colors.[46]

Paragraph 22 of FASB Statement No. 67 allows for a maximum period of one year after cessation of major construction activities, over which a developer may assert that the project is not substantially completed, by requiring that "[a] real estate project shall be considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer but no later than one year from cessation of major construction activity . . ."

Real estate projects may need to be divided into separate assets or parts for purposes of determining whether they are ready for their intended use. For example, a condominium building is comprised of individual condominiums, which can be used independently from each other.[47] Each such condominium constitutes a separate asset, and interest ceases to be capitalized on condominiums that have been completed and are ready for use. Other real estate assets must be completed in their entirety before any part of the asset can be used, such as the construction of a manufacturing facility.

Judgment must be exercised when determining whether a real estate project should be divided into separate parts for purposes of interest capitalization.

#### Step 4. Determine the Amount of Interest Cost to Be Capitalized

The amount of interest cost to be capitalized is intended to be that portion of the interest cost incurred during the asset's acquisition and construction period that theoretically could have been avoided if expenditures for the asset had not been made.[48]

45 FAS 34, paragraph 58
46 FAS 34, paragraph 58
47 FAS 34, paragraph 18
48 FAS 34, paragraph 12

The total amount of interest cost that may be capitalized in an accounting period is limited to the total amount of interest cost incurred by the company in that period.[49]

For purposes of FASB Statement No. 34,[50] interest cost incurred by a company includes:

- Interest recognized on obligations with explicitly stated interest rates (including the amortization of discount or premium and debt issue costs)
- Interest imputed on certain types of payables, in accordance with Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*
- Interest on capital leases determined in accordance with FASB Statement No. 13, *Accounting for Leases*

The amount of interest cost to be capitalized in an accounting period is determined by applying an interest rate to the average amount of accumulated expenditures for the asset during the period. In determining what interest rate to use, the objective is to determine a reasonable measure of the cost of financing the acquisition and development of the asset. The interest rate or interest rates used should be based on the rates applicable to borrowings outstanding during the period. If a company has obtained a specific loan for a qualifying asset, the company may use the rate on that borrowing as the capitalization rate for the expenditures for the asset. If the average accumulated expenditures for the asset exceed the amounts of that loan, the capitalization rate applied to any excess is a weighted average of the rates applicable to other borrowings of the company.[51] Paragraph 14 of Statement 34 provides with respect to the weighted average interest rate to be used: "In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing the acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances."

Section 1.7.6 of this chapter discusses special considerations if financing is provided by related parties. It also discusses interest capitalization by a company on investments in an equity method investee.

**1.2.3 COST ALLOCATION** As real estate projects often span long time periods until their completion, it is of critical importance to evaluate at the outset of a real estate project whether—for cost allocation purposes—a project should be divided into two or more phases. For example, a real estate development company may purchase a large tract of land to be developed over several years; portions of the land will be developed and sold before the project as a whole is completed.

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49 FAS 34, paragraph 15
50 FAS 34, paragraph 1
51 FAS 34, paragraph 13

If that real estate development project is not divided into phases, the appropriate allocation and monitoring of costs is difficult, and project costs relating to the earlier stages of the development may inappropriately be allocated to a later stage, thereby overstating profits in the earlier years. Certain project costs may benefit one individual unit (such as a lot, home, or condominium unit) or a group of units within one phase; other costs may benefit one or more phases of a project or more than one project, such as utilities or access roads. As such, the allocation of costs to individual units, between different phases of one project, or to different projects generally involves several cost pools and multiple steps.

When allocating project costs, one needs to consider costs already incurred, as well as costs to be incurred in current and future periods. For example, in a master-planned community, individual homes are often sold before amenities (for example, golf courses, swimming pools, or parks) have been completed. To appropriately reflect the cost of sales that relates to one individual home sold, a portion of the costs expected to be incurred in future periods for the construction of the amenities must be allocated to that home.[52]

Selecting an appropriate cost allocation method requires judgment. As a general rule, costs should be allocated to the portions of a project that benefit from the costs. The intent is to achieve a constant gross margin on sales for the project, irrespective of the point in time sales occur. FASB Statement No. 67 outlines three different ways to allocate costs:[53]

1. Specific identification method
2. Relative value method
3. Area methods or other value methods

#### Specific Identification Method

Where practicable, the costs of a real estate project are assigned to individual components of a project based on specific identification. The specific identification method is most frequently used for the allocation of acquisition costs and direct construction costs in small projects. For example, costs charged by a contractor to install a staircase in a new home directly relate to that home. The amount invoiced by the contractor should be included in the cost basis of that home.

#### Relative Value Method

If specific identification is not feasible or is impracticable, as is the case for indirect costs or common costs, costs should be allocated based on the relative value of the components, if possible.[54] Under this method, costs are allocated based on the relative fair values of the individual components of a project, based on either (1) the fair value before construction or (2) the relative sales value of the units.

52 The accounting for costs of amenities is further discussed in Section 1.7.1.
53 FAS 67, paragraph 11
54 FAS 67, paragraph 11

**Allocation Based on Relative Fair Value before Construction.** Land costs and all other common costs incurred before construction occurs (including the costs of any amenities) are allocated to the land parcels benefited, with cost allocation based on the relative fair value before construction. For example, a developer that purchases a tract of land on which to build a master-planned community, a shopping center, and an office building would allocate the cost of the land based on estimates of the relative fair value of the land parcels of (1) the master-planned community, (2) the shopping center, and (3) the office building, prior to the construction of the structures. A cost allocation based on the size of the parcels would not reflect any differences in values and is generally not considered appropriate. Unusable land and land that is donated to municipalities or other governmental agencies that will benefit the project are allocated as common costs of the project.[55]

**Allocation Based on the Relative Sales Value of the Units.** Under the relative value method, construction costs for a project, such as a condominium complex, are allocated to the individual units (for example, homes, condominium units) based on the relative sales value of the units.[56] When allocating costs based on the relative value method, the sales values of the units must be comparable. This is achieved by assuming that all of the units will be completed and ready for sale at the same point in time; any expected price increases for units that will be completed in future periods are not taken into consideration.

The relative sales value method results in allocating greater costs to more valuable components of a project. In practice, the relative value method is often implemented through the application of a gross profit method. Under the gross profit method, a cost-of-sales percentage is calculated by dividing the sum of capitalized project costs and project costs to be incurred in the current and future periods by the estimated sales value of the unsold units. When a unit is sold, the cost-of-sales amount attributable to that sale is determined by multiplying the sales value of that unit by the cost-of-sales percentage.

#### Area Methods or Other Value Methods

If the relative value method cannot be applied, as would be the case if a real estate development company has not determined the ultimate use of the land, another method for cost allocation has to be used. FASB Statement No. 67 suggests the use of the area method, such as the allocation of costs to parcels based on square footage, or "another reasonable value method."[57]

Under the area method, costs are allocated based on lot sizes, the square footage of a structure, or the number of units in a development. The use of the area method is appropriate only if the allocation is not materially different from

55 FAS 67, paragraph 14
56 FAS 67, paragraph 11
57 FAS 67, paragraph 11

an allocation that is based on relative value methods, or if the application of the relative value method is impracticable.

| EXAMPLE—COST ALLOCATION |
|---|
| Developers-R-Us (D) purchases land for \$10 million, which it intends to divide into three parcels. On Parcel 1, which is along the highway, it plans to construct a shopping center. On Parcel 2, which is behind the shopping center, D plans on building a row of 40 townhouses. Parcel 3 will be developed into a master-planned community. The fair value of the land before construction has been determined to be \$4 million, \$1 million and \$5 million for parcels 1, 2, and 3, respectively. The sales prices for the shopping center, the town houses, and the master-planned community are estimated to amount to \$40 million, \$12 million, and \$100 million.<br>How much land cost should be allocated to Townhouse Unit 1 (TH 1), which has an estimated sales price of \$500,000?<br>The first step is to allocate the cost of the land to the individual parcels based on the relative fair value before construction; accordingly, an amount of \$1 million is allocated to Parcel 2. The land value allocated to the parcel on which townhouses are to be constructed then becomes part of the common cost pool for the townhouse, which is allocated to each townhouse based on its relative sales value. As such, TH 1 will be allocated land costs of \$41,667. That amount is calculated as follows:<br>The sales value of TH 1 divided by the sales value of all THs, multiplied by the cost of land allocated to the townhouse development:<br>\$0.5 million/\$12 million multiplied by \$1 million |

The allocation of costs needs to be reviewed every reporting period to ensure that changes in circumstances, such as a change in estimate of project costs or sales prices or in the design of the project, are taken into consideration.[58] Cost reallocations within or between phases of a project are not uncommon, as the design of a project may evolve.

**1.2.4 CHANGE IN ESTIMATES OR PROJECT PLANS AND ABANDONMENTS OF PROJECTS** Due to the length of time involved in the development and construction of real estate properties, a project's plans, cost estimates, and expected sales prices may change over the course of the project.

CHANGE IN ESTIMATES

Paragraph 12 of FASB Statement No. 67 requires that estimates and cost allocations be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Generally, any changes in cost estimates are accounted for prospectively as changes in estimate, in accordance with paragraphs 19 through 22 of FASB Statement No. 154, *Accounting Changes and Error Corrections*.

58 FAS 67, paragraph 12

The accounting for any cost revisions may be reflected in the current period or in current or future periods, depending on the facts and circumstances:

- If the difference in cost estimates relates to direct costs for units already sold, such as additional sales commissions, they are charged to expense at the time the information becomes available to the developer.
- If the difference in cost estimates arises from an increase or decrease in common costs—streets, utilities, etc.—any cost increases or decreases are accounted for prospectively.

The prospective accounting for changes in common cost estimates can lead to different margins over the time of project development and construction. If cost estimates for common costs increase, common costs attributable to units already sold will be allocated to the costs of unsold units.[59] Consequently, the profit margin of units sold in future periods would be lower than the profit margin of units already sold.

Changes in estimates in sales values, which impact cost allocation under the relative value methods, are also accounted for as a change in estimate pursuant to paragraphs 19 through 22 of FASB Statement No. 154.

#### Change in Development Plans

Changes in market demand or other factors may arise after significant development and construction costs have already been incurred (such as the change in the housing market in the summer of 2007). If a developer decides to change its development plans, development and construction costs need to be charged to expense to the extent that the capitalized costs incurred and to be incurred for the redesigned project exceed the estimated value of the redesigned project when it is substantially complete and ready for its intended use.[60] This charge to expense based on the fair value upon completion is required irrespective of whether an impairment loss needs to be recognized pursuant to the provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

When determining the amount to be charged to expense upon such change in plans, any future interest capitalization has to be taken into consideration pursuant to paragraph 19 of FASB Statement No. 34, *Capitalization of Interest Cost,* which provides, in part:

> Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

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59 The prospective accounting for changes in estimated project costs required by paragraph 12 of FASB Statement No. 67 differs from the accounting for a change in estimated costs for construction contracts. Paragraph 83 of SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts,* requires the use of the cumulative catch-up method when accounting for any revisions to revenue, cost, and profit estimates for long-term construction contracts. Under the cumulative catch-up method, a change in estimate is accounted for in the period of change so that the balance sheet at the end of the period of change and the accounting in subsequent periods are as they would have been if the revised estimate had been the original estimate.

60 FAS 67, paragraph 15

ABANDONMENT OF A REAL ESTATE PROJECT

If a real estate project is abandoned, the capitalized costs of that project need to be expensed to the extent they are not recoverable. Any capitalized expenses for which a future use cannot be clearly established should not be allocated to other phases or other projects.[61]

## 1.3 COSTS INCURRED TO SELL OR RENT A REAL ESTATE PROJECT

In real estate properties that are intended for rent or sale after development is completed, leasing and selling activities generally occur throughout the acquisition, development, and construction phases of a project. Successful preleasing and preselling efforts are evidence of a project's viability, and funds received from buyers are often used to finance a project's development. Commissions; legal fees; closing costs; advertising costs; and costs for grand openings are examples of costs to sell or rent; however, based on the type of real estate property, leasing and sales activities—and related costs incurred—may vary.

**1.3.1 COSTS INCURRED TO SELL A REAL ESTATE PROJECT** Costs incurred to sell a real estate project are generally substantial. Depending on the type of selling costs incurred, they are accounted for in one of three ways:

- Included in project costs
- Deferred
- Expensed

SELLING COSTS TO BE INCLUDED IN PROJECT COSTS[62]

Selling costs are included in project costs if all of the following criteria are met:

- They are reasonably expected to be recovered from the sale of the project or from incidental operations
- They are incurred for:
  - Tangible assets that are used directly throughout the selling period to aid in the sale of the project, or
  - Services that have been performed to obtain regulatory approval of sales

Examples of costs that generally qualify as project costs are:[63]

- Costs of model units and their furnishings
- Costs of sales facilities
- Legal fees for the preparation of prospectuses
- Costs of semipermanent signs.

Selling costs that qualify for inclusion in project costs become part of a common cost pool that is allocated to individual units. Model units and their furnishings are

61 FAS 67, paragraph 13
62 FAS 67, paragraph 17
63 FAS 67, paragraph 17

generally sold at the end of the sales period; the amount allocated to common costs is the excess of the costs of the model units over their estimated sales proceeds.

### Selling Costs to Be Deferred[64]

FASB Statement No. 67 provides for the deferral of certain selling costs. It is important to note that deferred selling costs are not part of project costs. If the percentage-of-completion method were applied, the incurrence of selling costs would not increase a project's percentage of completion. Additionally, deferred selling costs are not part of qualifying expenditures for interest capitalization.

Selling costs are accounted for as prepaid costs; that is, they are deferred if they meet the following criteria: They must be directly associated with successful sales efforts, and their recovery must be reasonably expected from sales. FASB Statement No. 67 provides for the deferral of such selling costs until the related profit is recognized. If profit is recorded under the accrual method of accounting, a deferral of selling costs is generally not necessary, as the selling costs are incurred in the period of sale. For example, a seller may incur brokerage commissions at the time of closing. If profit from a real estate sale is recognized under a method of accounting other than the accrual method, such as the deposit or installment method, paragraph 18 of Statement 67 provides for cost deferral until the related profit is recognized.

If a sales contract is canceled or if the receivable from a real estate sale is written off as uncollectible, any related unrecoverable deferred selling costs are charged to expense.[65]

### Advertising Costs

Costs of advertising, which include the costs of producing advertisements (such as the costs of idea development, artwork, printing, and audio and video production) and communicating advertisements that have been produced (such as the costs of magazine space, television airtime, billboard space, and distribution costs) are accounted for based on the provisions of SOP 93-7, *Reporting on Advertising Costs.*

Costs of advertising are expensed, either as incurred or the first time the advertising takes place (e.g., the first public showing of a television commercial or the first appearance of a magazine advertisement) with the following two exceptions provided for in paragraphs 26 and 27 of that SOP.

1. Direct-response advertising whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and that results in probable future economic benefits. Costs of direct response advertising that are capitalized should be amortized over the period during which the future benefits are expected to be received.[66]

64 FAS 67, paragraph 18
65 FAS 67, paragraph 19
66 SOP 93-7, paragraph 46

2. Expenditures for advertising costs that are made subsequent to recognizing revenues related to those costs. For example, a company may assume an obligation to reimburse its customers for some or all of the customers' advertising costs (cooperative advertising). In that scenario, revenues related to the transactions creating those obligations are earned and recognized before the expenditures are made. For purposes of applying SOP 93-7, those obligations should be accrued and the advertising costs should be expensed when the related revenues are recognized.

### Selling Costs to Be Expensed[67]

Costs that do not meet the criteria for capitalization as project costs or for cost deferral are expensed as incurred.

### Example—Selling Costs

Developers-R-Us (D) sells developed lots. The buyers of the lots have made only nominal down payments, and D has determined that the application of the deposit method of accounting is appropriate. D intends to defer the following five types of costs incurred in connection with D's efforts to sell the lots:

1. Wages and commissions paid to sales personnel, and related insurance, taxes, and benefits for sales personnel
2. Costs for the corporate sales department
3. Radio and newspaper advertising expenses
4. Telephone, hospitality, meals, and travel costs for customers and prospective customers
5. Title insurance and professional fees incurred in the sale

D intends to defer these costs, as they are incurred in connection with D's efforts to sell the lots. Is a deferral of these costs appropriate?

1. To the extent the costs for wages and commissions to sales personnel relate directly to successful sales efforts, their deferral (together with the deferral of any related insurance, taxes and benefits) is appropriate.
2. Costs of the corporate sales department are not directly associated with successful sales and should not be deferred.
3. For advertising costs, the guidance in SOP 93-7 should be followed.
4. To the extent that telephone, hospitality, meals, and travel costs for customers and prospective customers are incurred directly for successful sales efforts, their deferral is appropriate.
5. Title insurance and professional fees are incurred directly in connection with the sales; their deferral is appropriate.

The AICPA has issued SOP 04-2, *Accounting for Real Estate Time-Sharing Transactions*, which includes guidance relating to the deferral of costs for the sale of time-sharing intervals. That guidance may provide additional insights when considering what types of selling costs to defer.

67 FAS 67, paragraph 19

**1.3.2 COSTS INCURRED TO RENT A REAL ESTATE PROJECT[68]** Costs to rent a real estate project under operating leases fall in one of two categories: (1) initial direct costs and (2) other than initial direct costs. Costs to rent projects under direct financing or sales-type leases are treated like costs to sell.

FASB Statement No. 67 does not apply to initial direct costs.[69] Initial direct costs are incremental direct costs incurred by the lessor in negotiating and consummating leasing transactions, and certain costs directly related to specified activities performed by the lessor.[70] The accounting for such costs is provided in FASB Statement No. 13, *Accounting for Leases,* and further discussed in Section 4.5.2 of Chapter 4.

Costs other than initial direct costs to rent real estate projects under operating leases that are related to and are expected to be recovered from future rental operations are deferred (capitalized). Examples of such costs are costs of:[71]

- Model units and their furnishings
- Rental facilities
- Semipermanent signs
- Grand openings, and
- Unused rental brochures

Deferred rental costs that are directly related to a specific operating lease are amortized over the lease term. Deferred rental costs not directly related to revenue from a specific operating lease are amortized over the period of expected benefit. The amortization period of capitalized rental costs begins when the project is substantially complete and held available for occupancy. Any amounts of unamortized capitalized rental costs associated with a lease or group of leases that are estimated not to be recoverable are charged to expense when it becomes probable that the lease or group of leases will be terminated.[72]

Costs of advertising are accounted for based on the provisions of SOP 93-7, *Reporting on Advertising Costs.*

Costs that do not meet the criteria for capitalization and are not advertising costs—for example, general and administrative costs—are expensed as incurred.[73]

## 1.4 INCIDENTAL OPERATIONS

Incidental operations are revenue-producing activities, such as rentals, that are undertaken during the holding or development period to reduce the cost of holding or developing the property for its intended purpose. For example, a developer

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68 Paragraphs 20 through 23 of FASB Statement No. 67 do not apply to real estate rental activity, in which the predominant rental period is less than one month. [FAS 67, paragraph 2]

69 FAS 67, paragraph 2(b)

70 FAS 13, paragraph 5(m)

71 FAS 67, paragraph 20

72 FAS 67, paragraph 21

73 FAS 67, paragraph 20

may engage in the following incidental operations to reduce the cost of project development:

- Operation of temporary parking facility on the future site of an office building before construction of the building commences
- Lease of undeveloped land for farming or for a golf driving range while the project is in the planning phase of development
- Lease of apartment building while it is converted into a condominium building

Incremental revenue from incidental operations in excess of incremental costs of incidental operations is accounted for as a reduction of development costs, whereas incremental costs from incidental operations in excess of incremental revenue from incidental operations are charged to current operations. The different accounting treatment reflects the intent for undertaking incidental operations; incidental operations are entered into to reduce the cost of developing the property for its intended use, rather than to generate revenues.[74] Accordingly, if the objective of reducing costs has not been achieved, any excess operating expenses from incidental operations are charged to expense.[75]

A real estate company may construct an office building that it intends to lease. Some offices may be leased before the office building is substantially complete and ready for occupancy. Until the building in its entirety is substantially complete and ready for occupancy, it is not depreciated, and any rental income and expense is accounted for as incidental operations.[76]

## 1.5 ACCOUNTING FOR COSTS INCURRED SUBSEQUENT TO PROJECT COMPLETION

**1.5.1 DETERMINING THE DATE OF PROJECT COMPLETION** A real estate project is considered substantially completed and held available for occupancy upon completion of tenant improvements by the developer, but no later than one year from cessation of major construction activity.[77] Once a real estate project is substantially completed and held available for occupancy, a rental project changes from nonoperating to operating, with the following consequences:

- Rental revenues and operating costs are recognized as they accrue
- Carrying costs (such as taxes and insurance) are expensed when incurred

74 FAS 67, paragraph 10

75 The accounting treatment of incidental operations under IFRS differs from the accounting treatment under U.S. GAAP. Paragraph 21 of IAS 16 provides, in part: "Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognized in profit or loss and included in their respective classifications of income and expense."

76 See also discussion under Section 1.5.1 of this chapter.

77 FAS 67, paragraph 22

- Interest capitalization ceases
- Depreciation commences
- Amortization of deferred rental costs commences

Paragraph 23 of Statement 67 states:

> If portions of a rental project are substantially completed and occupied by tenants or held available for occupancy, and other portions have not yet reached that stage, the substantially completed portions should be accounted for as a separate project. Costs incurred shall be allocated between the portions under construction and the portions substantially completed and held available for occupancy.

Judgment must be used to determine what constitutes a project and, once identified, when that project is substantially completed and ready for its intended use. For example, a company may identify separate buildings in an office complex as separate projects. However, an individual rental project, such as an office building, is considered one real estate project in its entirety, and that rental project is evaluated in its entirety of whether it is substantially complete. The FASB considered and rejected a phase-in of depreciation and other operating costs based on a percentage-of-occupancy method over the period of lease-up of a building.[78] As such, depreciation commences for an office building held for rental in its entirety, rather than on a floor-by-floor basis. Similarly, costs incurred for property taxes and insurance relate to the building and land as a whole and, therefore, capitalization of those costs should cease when the building is substantially complete and ready for its intended use, rather than being phased in over time.

**1.5.2 COSTS INCURRED SUBSEQUENT TO PROJECT COMPLETION** For properties that are developed for a company's own use or rental operations, costs will be incurred subsequent to the completion of the project. Questions of how to account for costs incurred subsequent to a property's completion are encountered not only by real estate companies, but by all companies owning real estate.

The accounting treatment of such costs will depend on the type of costs incurred and the reason for their incurrence. Costs incurred may be start-up costs within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities*;[79] they may constitute normal maintenance expenses; or they may stem from renovations, remodeling, or refurbishing activities.

Normal repair and maintenance costs are commonly expensed as incurred. Questions remain, however, with respect to other costs incurred. If a company replaces the roof of a building, for example, should that new roof be capitalized?

78 FAS 67, paragraph 38

79 Section 1.7.2 discusses the accounting for start-up costs.

If so, is it appropriate or necessary to write off the estimated net book value of the existing roof?

Aside from a general rule that expenditures that extend the life of the property or increase its value are capitalized and that normal recurring repair and maintenance expenditures are expensed, very little guidance exists with respect to the accounting treatment of costs incurred subsequent to project completion. The proposed SOP, *Accounting for Certain Costs and Activities Relating to Property, Plant, and Equipment*, offers guidance with respect to costs incurred during the "in service stage;" however, that proposed SOP was not cleared by the FASB. Additionally, the proposed SOP introduces the concept of components, which is generally not followed in U.S. Generally Accepted Accounting Principles (GAAP).

## 1.6 PURCHASE OF INCOME PRODUCING PROPERTY

A transaction to acquire real estate held for rental, commonly referred to as income-producing property, may constitute the purchase of a business or the purchase of an asset/asset group. The determination of whether an acquisition constitutes the acquisition of a business or of an asset/asset group is essential for the appropriate allocation of the purchase price.

**1.6.1 PURCHASE OF A BUSINESS** The main guidance for the determination of whether a business or an asset/asset group is being purchased is provided by EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.*[80] That Issue states:[81]

> A business is a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting

80 In December 2007, the FASB issued FASB Statement No. 141(R), *Business Combinations*, which will replace FASB Statement No. 141 and nullify EIT Issue No. 98-3. FASB Statement No. 141(R) defines a business as follows: "A *business* is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants." [FAS 141(R), paragraph 3(d)]. That Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

81 Unlike EITF Issue No. 98-3, FASB Statement No. 141(R) does not require outputs for an integrated set of activities and assets to qualify as a business. Paragraph A5 of FASB Statement No. 141(R) explains: "To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes."

> outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing its outputs to customers.[82]

EITF Issue No. 98-3 outlines a three-step process to determine whether a transferred set of assets and activities is a business:[83]

**Step 1:** Identify the elements included in the transferred set.

**Step 2:** Identify any missing elements through a comparison of the elements identified in Step 1 with the complete set of elements necessary to conduct normal operations.

**Step 3:** If any elements are missing, assess whether these missing elements are minor. If the missing elements are minor, their absence would not lead to the conclusion that the transferred set of assets is not a business. When assessing whether missing elements are minor, factors such as the uniqueness or scarcity of the missing element, the time frame, level of effort and cost required to obtain the missing element should be considered.

Often, the evaluation of whether or not a set of activities and assets acquired constitutes a business requires significant judgment.

If all but a *de minimis* amount of the fair value of the transferred set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being received in the transfer.[84] On the other hand, if goodwill is present in a transferred set of activities and assets, it should be presumed that the excluded items are minor and that the transferred set is a business.[85]

The purchase of individual income-producing properties, such as office buildings or warehouses, does often not constitute the acquisition of a business, whereas the purchase of a hotel or restaurant may very well constitute the acquisition of a business, depending on the components included in the transfer.[86] It is important to note that the manner in which the purchaser intends to operate the purchased set of activities and assets is not relevant to the determination of whether a business or an asset group is being purchased.

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82 EITF Issue No. 98-3, paragraph 6

83 EITF Issue No. 98-3, paragraph 6; FASB Statement No. 141(R) does not include a process similar to the three-step process outlined in EITF Issue No. 98-3.

84 EITF Issue No. 98-3, paragraph 6; the guidance in FASB Statement No. 141(R) does not include a similar indicator.

85 EITF Issue No. 98-3, paragraph 6; like EITF Issue No. 98-3, FASB Statement No. 141(R) provides that the presence of goodwill creates the presumption that a set of assets and activities is a business. [FAS 141(R), paragraph A9]

86 EITF Issue No. 98-3 provides examples relating to the determination of whether a transfer of hotels and restaurants constitutes a business. [EITF Issue No. 98-3, Exhibit 98-3A, Examples 2 and 3]

**1.6.2 PURCHASE OF AN ASSET/ASSET GROUP** If the purchase of real estate does not meet the criteria of a business as established in EITF Issue No. 98-3,[87] it constitutes the purchase of an asset/asset group.[88]

One key accounting difference between the acquisition of an asset/asset group and the acquisition of a business is that in the acquisition of a business, the assets acquired and liabilities assumed are recorded at their fair values, with any excess of acquisition cost over the amounts assigned to the assets acquired and liabilities assumed being recognized as goodwill.[89] In an asset acquisition, on the other hand, the allocation of the purchase price is based on the *relative* fair values of the individual assets and liabilities of the purchased set.[90] The *relative* fair values of the assets purchased and liabilities assumed may differ from their fair values. Section 1.6.5 in this chapter includes an example that illustrates the purchase price allocation in the acquisition of a business versus the acquisition of an asset group.

**1.6.3 RECOGNITION OF INTANGIBLE ASSETS ACQUIRED** Before the issuance of FASB Statements No. 141, *Business Combinations* and No. 142, *Goodwill and Other Intangible Assets*, the purchase price for income-producing real estate was generally allocated to land and buildings. Any intangibles acquired, such as lease agreements, were considered part of the value of the land or buildings and not separately accounted for. Statements 141 and 142 have changed the way acquisitions of income-producing real estate properties are being accounted for. In both pronouncements, the FASB mandates that intangible assets be identified and recognized separately from land and buildings.[91] This has resulted in a change to previous accounting practice.

RECOGNITION CRITERIA IN BUSINESS ACQUISITIONS VS. ASSET ACQUISITIONS

In the acquisition of a business, an intangible asset is recognized as a separate asset only if one of the following two criteria is met:[92]

1. The asset arises from contractual or other legal rights.
2. The asset is separable, that is, capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so).[93]

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87 For business combinations with an acquisition date on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, FASB Statement No. 141(R) applies.

88 Similar guidance is provided in FASB Statement No. 141(R): If the assets acquired and liabilities assumed are not a business, a purchase transaction is accounted for as an asset acquisition. [FAS 141(R), paragraph 4]

89 FAS 141, paragraphs 35 and 43

90 FAS 141, paragraph 9

91 FAS 141, paragraph 7; FAS 142, paragraph 9

92 Under FASB Statement No. 141(R), the acquirer recognizes, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. [FAS 141(R), paragraph 12] Paragraph 3(k) of FASB Statement No. 141(R) provides that an "asset is *identifiable* if it either: (1) Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or (2) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations."

93 FAS 141, paragraph 39

In a purchase of income-producing property that does not meet the definition of a business, however, all intangible assets that meet the asset recognition criteria in Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, must be recognized in the financial statements, even though they may not meet either of these two asset recognition criteria.[94]

#### Intangibles in the Acquisition of Income-Producing Properties

Intangibles commonly encountered in the acquisition of income producing real estate properties[95] are:

- In-place leases
  - at-market component
  - above- and below-market component
- Tenant (customer) relationships

Other intangible assets, such as tenant (customer) lists or trade names, may also be present, depending on the individual facts and circumstances.

**In-Place Leases.** Companies acquiring income-producing properties segregate leases that are in place at the date of acquisition ("in-place leases") into (1) an at-market component and (2) an above- and below-market component.

The at-market component of in-place leases represents the value of having lease contracts in place at terms that are market. The above- and below-market component of in-place leases represents the present value of the difference in cash flows between the contractually agreed-upon rentals and current prevailing rental rates for the in-place leases. If in-place leases are above-market, they represent assets from the acquiring company's perspective, because the acquiring company will receive rentals that are above market in future periods. If in-place leases are below-market, they represent liabilities (balance sheet credits). The above- and below-market components of acquired leases are determined on a lease-by-lease basis. As such, the acquisition of one income-producing property may result in both above-market leases (assets) and below-market leases (liabilities [balance sheet credits]); the amounts of above- and below-market leases are not presented "net" on the balance sheet.

**Tenant Relationships.** A tenant relationship is a relationship between the lessor of the property and its tenants, akin to a customer relationship.[96]

FASB Statement No. 141 states with respect to customer relationships:[97]

> For purposes of this Statement, a customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make

94 FAS 142, paragraphs 9 (footnote 7) and B37
95 In both business acquisition and asset acquisition
96 FAS 141, paragraph F1; EITF Issue No. 02-17
97 FAS 141, paragraph F1

direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives.

A tenant relationship may provide the landlord with the ability to generate a future income stream besides rentals from in-place leases; for example, a landlord may be able to attract an anchor tenant of one shopping mall to its other shopping malls. Or a well-known anchor tenant, such as a high-end retailer, may act as a magnet for other tenants.[98]

**1.6.4 VALUATION OF LAND, BUILDINGS, AND INTANGIBLES** Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.[99]

The FASB provides the following general guidance regarding the valuation of individual assets acquired in a business combination:

- Land at appraised values[100]
- Plant and equipment
  - Plant and equipment to be used at the current replacement cost, unless the expected future use of the assets indicates a lower value to the acquiring entity[101] (replacement cost can be estimated from the replacement cost new less estimated accumulated depreciation[102])
- Plant and equipment to be sold at fair value less cost to sell[103]
- Intangible assets at their estimated fair values[104]

An intangible asset arising from a contractual or other legal right represents the future cash flows that are expected to result from the ownership of that contractual or legal right.[105] The FASB observed that "a contract may have value for reasons other than terms that are favorable relative to market prices. The Board therefore concluded that the amount by which the terms of a contract are favorable relative to market prices would not always represent the fair value of that contract."[106]

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98 Views differ as to whether to include the fair value arising from expected future lease renewals in the intangible asset *in-place leases*, or whether to consider that fair value in the intangible asset *tenant relationships*.

99 FAS 157, paragraph 5; prior to changes effected by FASB Statement No. 157, fair value is defined as the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. [FAS 142, Appendix F, paragraph F1]

100 FAS 141, paragraph 37(f)

101 FAS 141, paragraph 37(d)(1)

102 The SEC has indicated in comment letters to SEC registrants that the fair value of buildings acquired in an asset purchase should be determined on an as if-vacant basis.

103 FAS 141, paragraph 37(d)(2)

104 FAS 141, paragraph 37(e)

105 FAS 141, paragraph B172

106 FAS 141, paragraph B41

Since the issuance of Statements 141 and 142, industry practice, largely driven by Securities and Exchange Commission (SEC) comment letters, has developed with respect to identifying and measuring the individual assets and liabilities (balance sheet credits) that are recorded upon the acquisition of real estate properties. Changes to prior industry practice relate primarily to the valuation of buildings—to be valued on an as if-vacant basis—and the separate recognition and valuation of in-place leases.

The requirement to measure intangibles at fair value necessitates a consideration of future contract renewals, consistent with FASB's view that estimates used should incorporate assumptions that market participants would use in making estimates of fair value.[107] In a lease with renewal options granted to the lessee, it appears appropriate to assume that a lessee would likely not renew a lease at above-market terms, and that a lessee would renew the lease if it could renew at below-market terms (or if the lessee were to incur a contractual or economic penalty if it decided not to exercise its renewal option).[108]

### In-Place Leases at Market

With respect to the valuation of in-place leases at market, one possible valuation approach may be to calculate—from an investor's perspective—the present value of the cash flow difference of acquiring the property with the in-place leases (at current market rates) versus acquiring the property without leases in place and having to lease up the property. That cash flow differential is an approximation of the difference a seller would expect to receive when selling a building already leased up versus selling a building without leases in place. The following elements are often significant when evaluating that cash flow differential in the purchase of income-producing properties:

- Lost rental revenue over the expected lease-up period
- Additional operating costs incurred as a result of not receiving tenant reimbursements
- Expenses relating to leasing commissions and legal fees to be incurred
- Reduced maintenance expenses for property not leased

As the accounting literature does not prescribe any particular valuation method, other methods may be used if they are consistent with the general

107 FAS 141, paragraph B174; FAS 142, paragraph B42

108 Views differ as to whether or not to include the fair value of expected future lease renewals in the intangible asset *in-place leases*, or whether to consider that fair value in the intangible asset *tenant relationships*.

guidance provided by Statements 141 and 142 that intangibles be measured at their fair values.[109]

In-Place Leases Above- and Below-Market

The fair value of the above- and below-market component of in-place leases is generally determined by calculating the present value of the difference in cash flows between the contractually agreed-upon rentals and current prevailing rental rates for the leases in place in the same geographic area at the time of acquisition.

**1.6.5 ALLOCATION OF ACQUISITION COST** In the purchase of real estate property that meets the definition of a business, the acquisition cost is allocated to the assets acquired and liabilities assumed based on their fair values. Any excess of cost over the amounts assigned to assets acquired and liabilities assumed is recognized as goodwill.[110]

If the purchase of real estate does not constitute a business, the acquisition cost is allocated to the individual assets and liabilities acquired based on their *relative* fair values.[111] The allocation of the acquisition cost based on the fair values of individual assets and liabilities, with a residual being allocated to one of the elements, is not an acceptable method. The SEC staff has expressed the following view with respect to the use of a residual method in business combinations, the concept of which applies—by analogy—to asset acquisitions also:[112]

> Some have asserted that the residual method provides an acceptable approach for determining the fair value of the intangible asset to which the residual is assigned, either because it approximates the value that would be attained from a direct value method or because they believe that other methods of valuation are not practicable under the circumstances. Others have indicated that the residual method should be used as a proxy for fair value of the intangible asset in these situations, since the fair value of the intangible asset in question is not determinable. . .

109 FAS 141, paragraph 37(e); paragraph 36 of FASB Statement No. 141 provides that the following may be useful in determining the estimated fair values of assets acquired and liabilities assumed: "Among other sources of relevant information, independent appraisals and actuarial or other valuations may be used as an aid in determining the estimated fair values of assets acquired and liabilities assumed . . ."

110 If the fair value of the assets acquired and liabilities assumed were to exceed the cost, such excess would be allocated as *pro rata* reduction of long-lived assets. [FAS 141, paragraph 44] Under FASB Statement No. 141(R), any excess of the fair value of the identifiable net assets acquired and liabilities assumed over the fair value of the consideration transferred (and the fair value of any noncontrolling interest in the transferee) would be recognized in earnings as a gain attributable to the acquirer. [FAS 141(R), paragraphs 34 and 36]

111 FAS 142, paragraph 9

112 EITF Topic No. D-108, *Use of the Residual Method to Value Acquired Assets Other Than Goodwill*

> The SEC staff believes that the residual method does not comply with the requirements of Statement 141. . . . The SEC staff notes that a fundamental distinction between other recognized intangible assets and goodwill is that goodwill is both defined and measured as an excess or residual asset, while other recognized intangible assets are required to be measured at fair value. The SEC staff does not believe that the application of the residual method to the valuation of intangible assets can be assumed to produce amounts representing the fair values of those assets.

The requirement in FASB Statement No. 142 to allocate the purchase price in an asset acquisition based on the *relative* fair values of the assets acquired and liabilities assumed is frequently implemented as follows:

#### Acquisition Cost Exceeds Fair Value of Net Assets Acquired

Any difference between the acquisition cost and the fair value of the net assets acquired is allocated to the assets acquired based on their relative fair values, except for financial assets (other than investments accounted for by the equity method), assets that are subject to a fair value impairment test, such as inventories, and any indefinite-lived assets. Allocating cost to these assets in an amount above their fair values would frequently require the recognition of an impairment loss subsequent to the acquisition of the asset group.

#### Fair Value of Net Assets Acquired Exceeds Acquisition Cost

Any difference is generally allocated consistent with the allocation method for negative goodwill, as described in paragraph 44 of FASB Statement No. 141:

> That excess shall be allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets . . . except (a) financial assets other than investments accounted for by the equity method, (b) assets to be disposed of by sale, (c) deferred tax assets, (d) prepaid assets relating to pension or other postretirement benefit plans, and (e) any other current assets.
>
> The acquired assets include research and development assets acquired and charged to expense in accordance with paragraph 5 of Interpretation 4 (refer to paragraph 42).

Although in most asset acquisitions, the relative fair values of the assets and liabilities will not exactly match the acquisition cost, a relatively large discrepancy between the acquisition cost and the fair value of the assets acquired and liabilities assumed may be an indication that either (1) not all intangibles have been identified, or (2) certain fair value determinations are not appropriate.

## EXAMPLE—ACQUISITION OF INCOME-PRODUCING REAL ESTATE

This example illustrates the difference in the initial recording of the tangible and intangible assets acquired based on the assessment, whether the purchase of real estate property is the acquisition of a business or the acquisition of an asset/asset group.

Company B purchases a hotel for a purchase price of $10m. The fair values of the individual components amount to:

| | |
|---|---|
| Land: | $4 million |
| Hotel building: | $3 million |
| Tenant improvements: | $0.2 million |
| In-place leases, at market: | $0.6 million |
| In-place leases, above market: | $1 million |
| Tenant relationships:[113] | $0.2 million |
| Total: | $9 million |

Scenario 1: The purchase of the hotel is the purchase of a business.
Scenario 2: The purchase of the hotel does not constitute the purchase of a business.
How would Company B record the acquisition under Scenarios 1 and 2?

**SCENARIO 1:** Company B would record the purchase of the hotel as follows:

| | |
|---|---|
| Land: | $4 million |
| Hotel building: | $3 million |
| Tenant improvements: | $0.2 million |
| In-place leases, at market: | $0.6 million |
| In-place leases, above market: | $1 million |
| Tenant relationships: | $0.2 million |
| Goodwill: | $1.0 million |
| Total: | $10 million |

The fair values of the identifiable tangible and intangible assets amount to $9 million. The residual amount of $1 million represents goodwill.

**SCENARIO 2:** Company B would record the purchase of the hotel as follows:

| | |
|---|---|
| Land: | $4.45 million (*) |
| Hotel building: | $3.33 million |
| Tenant improvements: | $0.22 million |
| In-place leases, at market: | $0.67 million |
| In-place leases, above market: | $1.11 million |
| Tenant relationships: | $0.22 million |
| Total: | $10 million |

The tangible and intangible assets are recorded at their relative fair values. The difference between the acquisition cost ($10 million) and the fair values of the tangible and intangible assets ($9 million) is allocated to the identified tangible and intangible assets based on their fair values.

(*) Rounding difference

113 Tenant relationships in a hotel or resort may result from relationships with the owners of gift stores or the operators of amenities, from relationships with recurring customers established through frequent stay programs, conventions, and conferences, for example.

**1.6.6 ACCOUNTING SUBSEQUENT TO ACQUISITION** FASB Statement No. 142 provides that the accounting for recognized intangible assets is based on their useful lives to the reporting entity.[114] The useful life of an intangible asset to a company is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of the company. An intangible asset is amortized over its expected useful life to the company using a method of amortization that reflects the pattern in which the economic benefits of the intangible asset are consumed or used up. A straight-line amortization method is deemed appropriate if that pattern cannot be reliably determined.[115] The amount of an intangible asset to be amortized is the amount assigned to that asset at the time of acquisition less any residual value.[116]

The above- or below-market value of in-place leases is amortized over the remaining term of the leases (including any expected renewals if renewal assumptions were used to determine the fair value of the in-place leases[117]) and presented either as a reduction of or an addition to rental revenue. The theory behind that presentation in the income statement is that the acquirer paid a premium for above-market leases or received a discount for leases with contractual terms that are below-market. When including the amortization of the above- or below-market component of in-place leases in rental revenue, the revenue in the income statement more closely reflects rental revenue that represents market terms.

## 1.7 SPECIAL ACCOUNTING ISSUES

**1.7.1 COSTS OF AMENITIES** Amenities are facilities that benefit or enhance a real estate project; they are often used by a developer as a marketing tool, particularly in a soft real estate market. They include golf courses, swimming pools, lakes, parks, and marinas to make a development more desirable, as well as sewage treatment plants or other utilities required by regulatory authorities. Amenities may or may not be revenue-producing.

The costs to be capitalized for the construction of amenities are determined in accordance with the criteria for cost capitalization discussed in Section 1.2 of this chapter. As a general rule, FASB Statement No. 67 provides that costs of amenities be allocated among the land parcels that benefit from the amenities, to the extent that the development of the parcels is probable.[118] The term "land parcel" is to be interpreted broadly: It may be an individual lot, unit, or phase of a real estate project.

The accounting treatment of amenities depends on whether the developer intends to (1) sell or transfer the amenities in connection with the sale of individual

114 Goodwill and intangible assets with indefinite useful lives are not amortized. [FAS 142, paragraphs 16 and 18]

115 FAS 142, paragraph 12

116 FAS 142, paragraph 13

117 EITF Issue No. 03-9, paragraph 5: " . . . The Task Force noted that the useful life—the period over which an intangible asset is expected to contribute to an entity's cash flows—for amortization purposes should be consistent with the estimated useful life considerations used in the determination of the fair value of that asset."

118 FAS 67, paragraph 8

units, or (2) sell the amenities separately to a third party or retain and operate the amenities. For example, clubhouses may be transferred to a homeowners association upon completion or sell-out of a development, whereas golf courses may be retained and operated by a developer.

FASB Statement No. 67 provides the following guidance for the treatment of costs incurred in connection with the construction and operation of amenities:

#### Amenities That Are to Be Sold or Transferred in Connection with the Sale of Individual Units[119]

Amenities that are to be sold or transferred in connection with the sale of individual units are clearly associated with the development and sale of the units in a project. To the extent that the costs of amenities and any expected future operating costs to be borne by the developer—until they are assumed by the buyers of the individual units—are not recoverable through proceeds from a future sale of these amenities, they are considered common costs of the project. Any changes in estimates relating to construction costs, to the operating results of the amenities before they are assumed by the buyers of the individual units, or to the amenities' sales proceeds (if any) are treated as changes in estimates and accounted for prospectively in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*.

#### Amenities That Are to Be Sold Separately to a Third Party or Retained by the Developer[120]

If a developer plans to sell amenities to a third party or retain them, capitalizable costs in excess of the estimated fair value of the amenities as of the date of substantial completion are allocated as common project costs. If a change in cost or fair value estimate of the amenities occurs prior to the amenities being substantially completed, the allocation of the amenities' costs to common costs of the project is revisited. After the amenities are substantially completed, no cost reallocations are made; accordingly, a subsequent sale may result in a gain or loss, which is included in the period of sale.

Operating results for amenities that are sold separately to a third party or operated by the developer are treated as follows:[121]

- Operating income (or loss) from the amenities before they are substantially completed and available for use is included as a reduction of (or an addition to) common costs.
- Operating income (or loss) from the amenities after they are substantially completed is included in the current operating results of the developer.

See Exhibit 1.2 for a graphic depiction of the accounting for costs of amenities.

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119 FAS 67, paragraph 8(a)
120 FAS 67, paragraphs 8(b) and 9
121 FAS 67, paragraph 9

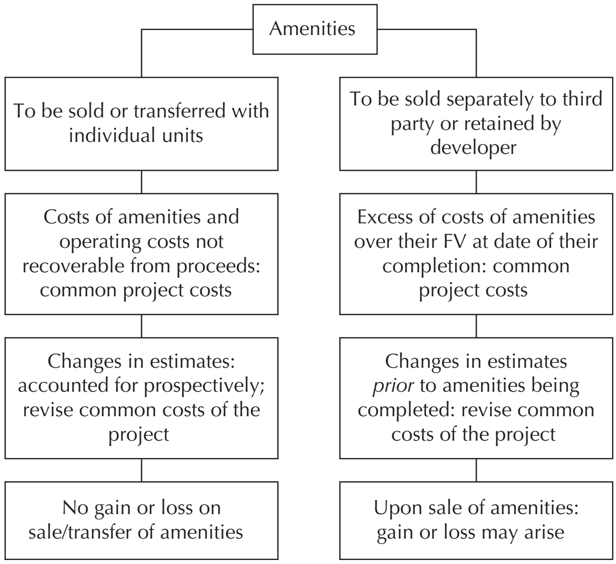


**Exhibit 1.2** Amenities

**1.7.2 START-UP COSTS** Start-up activities are one-time activities relating to opening a new facility, introducing a new product or service, conducting business in a new territory or with a new class of customer, initiating a new process, organizing a new entity, or commencing some new operation.[122] Start-up costs are costs incurred in connection with start-up activities; they are expensed as incurred.[123]

A retailer may construct a facility in which it plans to operate a new store. Between the time of completion of the facility and the store opening, there is typically a period of time during which start-up activities take place—for example, inventory may be stocked, employees may be trained, and registers may be tested. Costs incurred in connection with these activities are not part of the acquisition, development, and construction costs of the facility; they are start-up costs. Determining whether costs constitute start-up costs is based on the nature of the activities and not necessarily on the time period in which they occur; that is, start-up costs may be incurred before operations begin or after operations have begun, but before the normal productive capacity is reached.[124]

The following are some examples of start-up costs within the scope of SOP 98-5, *Reporting on the Costs of Start-Up Activities:*[125]

- Organization costs
- Training costs of employees

122 SOP 98-5, paragraph 5
123 SOP 98-5, paragraph 12
124 SOP 98-5, paragraphs 30 and 31
125 SOP 98-5, paragraphs 44 and 45

- Consultant fees
- Salaries and salary-related expenses for new employees
- Costs of recruiting
- Nonrecurring operating losses
- Amortization and depreciation of leasehold improvements and fixed assets that are used in the start-up activities

Examples for costs incurred in conjunction with start-up activities that are outside the scope of SOP 98-5 are:[126]

- Costs of acquiring or constructing long-lived assets[127]
- Costs of acquiring intangible assets[128]
- Internal-use computer software systems development costs
- Costs of acquiring or producing inventory
- Financing costs and costs of raising capital
- Advertising costs
- Security, property taxes, insurance, and utilities costs related to construction activities
- Costs incurred in connection with existing construction contracts[129]

**EXAMPLE—START-UP COSTS[130]**

ToyCo. (T), a retail chain, is opening a new store. T rents the store, which it will build out and furnish. T incurs capital expenditures for leasehold improvements and furniture. T expects that it will require three months to set up the store. Among the costs incurred during the three-month period are costs for security, property taxes, insurance, and utilities.

Can T capitalize these costs?

No. The building, although requiring some set-up costs (leasehold improvements, furniture) is substantially ready for its intended use upon entering into the lease, and no construction activities need to be performed in connection with the store. The costs for security, property taxes, insurance, and utilities are start-up costs within the scope of SOP 98-5 that should be expensed.

**1.7.3 LAND OPTIONS** Obtaining land options is a common means for land developers and homebuilders to secure land for future development without having to finance the land, incur carrying costs and bear the risk of a decline in

126 SOP 98-5, paragraphs 8, 44

127 The costs of using long-lived assets that are allocated to start-up activities (for example, depreciation of computers) are within the scope of SOP 98-5. [SOP 98-5, paragraph 8]

128 The costs of using intangible assets that are allocated to start-up activities are within the scope of SOP 98-5. [SOP 98-5, paragraph 8]

129 AcSEC believes that start-up costs incurred in connection with existing contracts (whether or nor incurred in anticipation of follow-on contracts) are contract costs related to a specific source of revenue subject to the accounting prescribed in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. [SOP 98-5, paragraph 39]

130 Adapted from SOP 98-5, paragraph 44 (Illustration 3).

land value. In exchange for the payment of an option premium, the option holder obtains the right to purchase the land under option at a fixed price over a certain period or at some future point in time. As discussed in Section 1.2.1, option premiums are preacquisition costs that qualify for cost capitalization.

The option holder may be required to consolidate the entity owning the land under option pursuant to the provisions of FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities*, rather than merely capitalizing the option premium. Whether the consolidation guidance in FIN 46(R) has to be evaluated depends on the counterparty to the transaction. If the land under option is owned by an individual, such as a farmer, no further considerations are necessary. If, however, the land under option is being held by a legal entity, the provisions of FIN 46(R) may apply. More often than not, land under option is held by a legal entity, because it provides the option holder with better control over the land under option; it also isolates the land from any liabilities of the owner. As such, holders of land options will likely have to consider FIN 46(R). When performing a FIN 46(R) analysis, holders of land options need to consider any other arrangements with the entity; they may have agreements in place to develop the land, to provide financing, or to guarantee certain obligations of the entity. Contractual arrangements between the entity owning the land and the option holder (or any related party) may constitute variable interests that impact the evaluation of whether the option holder has to consolidate the entity owning the land.

FIN 46(R) analyses are very complex; the following discussion intends to highlight some aspects that need to be considered when evaluating land options. It is not intended to cover all aspects that need to be considered.

#### Land under Option is Majority of Entity's Assets

A legal entity owns land and has granted to a homebuilder the option to purchase the land at a fixed price within a specified period of time. If the land under option represents the entity's only asset or a majority of the entity's assets when measured at fair value, the option is deemed a variable interest in the entity. In that case, the entity generally meets the definition of a variable interest entity (VIE) for the following reason: As a result of the option, the option holder has the ability to participate in the future appreciation of the land. In FIN 46(R)-speak, the entity's holders of equity investment at risk do not have the right to receive the entity's expected residual returns.[131] Whenever the holders of an entity's equity investment at risk do not have the right to receive the entity's expected residual returns, the entity meets the definition of a VIE.[132] The entity may also be considered a VIE for reasons other than the one cited, such as insufficient equity investment at risk.

131 If the deposit is nonrefundable, the option holder would also absorb expected losses of the entity.

132 FIN 46(R), paragraph 5(b)(3)

### Land under Option is not Majority of Entity's Assets

Variable interests in assets that comprise 50% or less of the fair value of an entity's assets are not variable interests in the entity and do not pose any FIN 46(R) consolidation issues, with the following two exceptions:

- The option holder holds another variable interest in the entity.
- A silo has been created.

**Option Holder Holds Another Variable Interest in the Entity.** Paragraph 12 of FIN 46(R) provides that a variable interest in specified assets of an entity that comprise 50% or less of the entity's assets is considered a variable interest in the entity if the variable interest holder holds another variable interest,[133] for example, an equity interest, in the entity itself. In that case, the entity would generally meet the definition of a variable interest entity for the reason outlined above.

**A Silo Has Been Created.[134]** Silos exist if the variability arising from specified assets inures to the benefit or detriment of variable interest holders in these assets, rather than to the benefit or detriment of variable interest holders in the entity. In other words, essentially none of the variability generated by these specified assets affects the expected losses or expected residual returns of the variable interest holders of the entity.

If such a silo exists, it has to be evaluated whether the entity meets the criteria of a variable interest entity. If the entity does not meet the criteria of a variable interest entity, no further FIN 46(R) considerations are necessary.

The FIN 46(R) considerations relating to land options are illustrated in Exhibit 1.3.

### Consolidation Considerations

Once it has been determined that the option holder holds a variable interest in a VIE or in any siloed assets of a VIE, the option holder has to evaluate whether it is the primary beneficiary (PB), that is, whether it has to consolidate the entity or silo.[135] The option holder may be the entity's primary beneficiary if the option holder and its related parties[136] absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both.[137]

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133 Except for interests that are insignificant or have little or no variability. [FIN 46(R), paragraph 12]

134 FIN 46(R), paragraph 13; FSP FIN 46(R)-1

135 A silo in a VIE is treated as a separate variable interest entity. Therefore, in the following discussion, no distinction has been made between an option holder that has an interest in a VIE and an option holder that has an interest in a silo of a VIE.

136 FIN 46(R), paragraph 16; for purposes of FIN 46(R), the term "related parties" includes the parties identified in FASB Statement No. 57, *Related Party Disclosures*, and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder.

137 FIN 46(R), paragraph 14

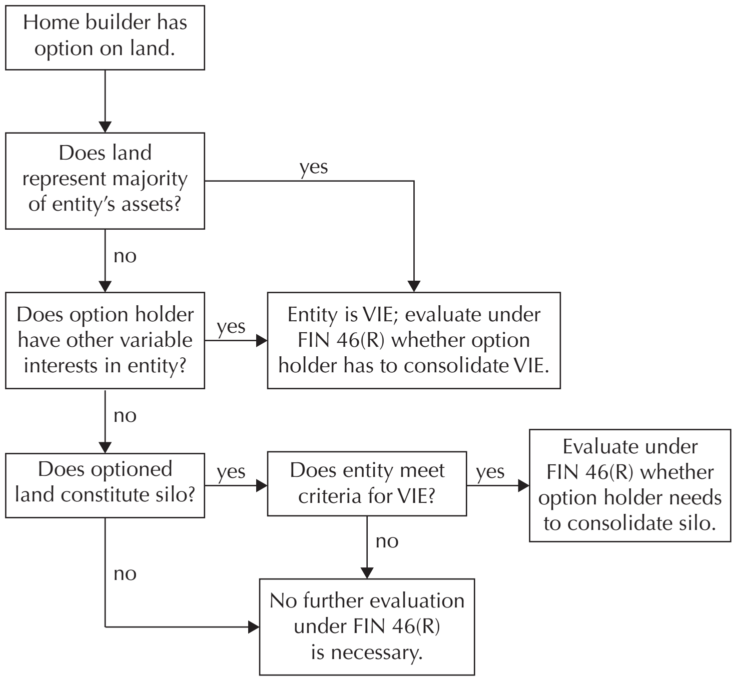


**Exhibit 1.3** FIN 46(R) Decision Tree—Land Options

### Example—Silo

Palm West LLC (LLC) is a newly created entity. Its only assets are three parcels of land, which have been contributed by its members. The LLC has obtained a mortgage loan on each of the three parcels of land approximating each parcel's fair value, and has distributed the amounts received under the loans to the members of the LLC. The mortgage loans are nonrecourse to the LLC or its members. The LLC writes a call option to a third-party homebuilder on one of the parcels, the exercise price of which approximates the parcel's fair value. If the land parcel increases in value, the option holder will benefit from the appreciation. If the land decreases in value, the option holder will likely not exercise the option, and the lender will have to absorb the losses, since the loan is nonrecourse to the LLC.

Does a silo exist with respect to the land under option?

Yes. The land is isolated from the remainder of the LLC. The members of the LLC do not participate in any appreciation of the land due to the option. They also have virtually no downside risk, as the LLC has obtained a loan approximating the fair value of the land. The entity meets the criteria of a VIE pursuant to paragraph 5(a)(1) of FIN 46(R), because it does not have any equity investment at risk. The option holder will have to perform a FIN 46(R) analysis to determine whether it has to consolidate the silo (consisting of the land and the mortgage on the land).

However, if the members of the LLC were subject to absorbing variability created by the land under option, a silo would not have been created. That would be the case, for example, if the borrowings on the land were substantially lower than the fair value of the land.

The features of the option, particularly refundability and amount of option premium relative to the fair value of the optioned land, play a major role when determining which variable interest holder is the primary beneficiary.

Certain option premiums may be *refundable* for a certain period of time, for example, to allow the option holder time to perform feasibility studies on the optioned land. As long as the option premium is refundable, the option holder does not have an obligation to absorb any of the entity's expected losses. If no other party absorbs a majority of the entity's expected losses, a FIN 46(R) analysis would nevertheless have to be performed to determine whether the option holder receives the majority of an entity's expected residual returns.

If option premiums are *nonrefundable*, the option holder's downside is limited to the option premium: If the fair value of the land under option were to decline by more than the option premium, the option holder would either not exercise the option or renegotiate the purchase price. As such, the size of the option premium is an important factor in the evaluation of which party absorbs the majority of the entity's expected losses. The larger the size of the option premium in relation to the fair value of the land, the more likely it is that the option holder will have to consolidate the entity.

**1.7.4 FINANCING AS PART OF A PURCHASE TRANSACTION** In real estate acquisitions, financing is often an integral part of the purchase transaction. The seller may provide financing to the buyer, or the buyer may assume a mortgage on the property. When financing is provided in an arm's-length transaction, there is a presumption that the stated interest rate is fair and adequate. This presumption is not appropriate when (1) the note does not have a stated interest rate, (2) the stated interest rate is unreasonable, (3) the stated face amount of the note (together with any down payment) is materially different from the current cash sales price for similar property, or (4) the stated face amount of the note is materially different from the market value of the note at the date of the transaction.[138]

If, in a purchase transaction, financing is provided at unreasonable rates, the property acquired should be recorded at (1) the fair value of the property or (2) an amount that approximates the market value of the note plus the fair value of any other consideration provided to the seller, whichever is more clearly determinable.[139] If such determination cannot be made due to a lack of established exchange prices or market value of the note, the present value of the note should be determined by discounting all future payments on the note using an imputed rate of interest. The rate used to determine the present value of the note is normally at least equal to the rate at which the debtor can obtain financing from other sources at the date

138 APB 21, paragraph 12
139 APB 21, paragraph 12

of the transaction. "The objective is to approximate the rate which would have resulted if an independent borrower and lender had negotiated a similar transaction under comparable terms and conditions with the option to pay the cash price upon purchase or to give a note for the amount of the purchase which bears the prevailing rate of interest to maturity."[140] Accordingly, the facts and circumstances of the individual transaction need to be considered. This includes an evaluation of the terms of the financing, any collateral and security provided to the lender, the down payment the purchaser has made, the credit rating of the purchaser, and tax consequences to the buyer and seller.[141]

If it has been determined that financing has been provided at an unreasonable rate and that the imputation of interest is required, the difference between the present value and the face amount of the note is treated as discount or premium and amortized as interest expense. The discount or premium is eligible for inclusion in the amount of interest cost capitalized in accordance with FASB Statement No. 34.[142]

Paragraph 16 of APB Opinion No. 21 provides with respect to the presentation of such premium or discount in the financial statements:

> The discount or premium resulting from the determination of present value in cash or non-cash transactions is not an asset or liability separable from the note which gives rise to it. Therefore, the discount or premium should be reported in the balance sheet as a direct deduction from or addition to the face amount of the note. It should not be classified as a deferred charge or deferred credit. The description of the note should include the effective interest rate; the face amount should also be disclosed in the financial statements or in the notes to the statements.

**1.7.5 ENVIRONMENTAL COSTS AND LIABILITIES** Property owners are required to comply with federal, state, and local laws that govern the removal and containment of environmental contamination in land and buildings. Being subject not only to current but also to future legislation, property owners may incur significant costs for known or yet undiscovered conditions or events.

Real estate acquisition and development is affected by accounting issues relating to environmental cleanup, particularly by issues relating to the recognition and measurement of liabilities, the accounting for environmental cleanup costs (that is, capitalization vs. expensing of costs), as well as financial statement presentation and disclosures. Depending on the type of contamination, different guidance applies to the accounting for costs incurred in connection with environmental cleanup.

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140 APB 21, paragraph 13
141 APB 21, paragraph 13
142 APB 21, paragraph 15

***1.7.5.1 Asset Retirement Obligations*** FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, provides guidance relating to legal obligations associated with the retirement[143] of a tangible long-lived asset that result from the acquisition, development construction, or the normal operation of the long-lived asset. "Retirement" is defined as the other-than-temporary removal of a long-lived asset from service, which includes its sale, abandonment, or disposal in some other manner.[144] Although not addressed further in this section, asset retirement obligations are not necessarily tied to environmental contamination or clean-up. For example, a landowner that grants a company the right to cut down timber may impose an obligation on that company to reforest the land at the end of the agreement.[145] Obligations may also be imposed on lessees, such as the obligation to remove leasehold improvements at the end of a lease. If the lessee is obligated to make or can be required to make such payments in connection with the leased property, the payments meet the definition of minimum lease payments;[146] FASB Statement No. 13, *Accounting for Leases*, rather than FASB Statement No. 143 applies to the obligations of a lessee that meet the definition of minimum lease payments or contingent rentals.[147] Determining whether an obligation to retire a leased asset should be accounted for as a minimum lease payment or as an asset retirement obligation is facts- and circumstances-based. As a general rule, if the obligation is directly related to the leased asset (or a component thereof), the lessee should account for the obligation in accordance with Statement 13. Conversely, if the asset retirement obligation relates to lessee-owned assets placed into service by the lessee at the leased premises, or if the asset retirement obligation relates to improvements made to the leased property by the lessee during the lease term, the lessee would generally account for them as asset retirement obligations following the provisions of Statement 143.

Legal obligations associated with the retirement of tangible long-lived assets, which give rise to asset retirement obligations, can result from (1) a government action, such as a law or statute, (2) an agreement between entities, or (3) a promise conveyed to a third party that imposes a reasonable expectation of performance.[148]

#### Recognition and Measurement

An asset retirement obligation should be recognized at fair value in the period in which it is incurred, if a reasonable estimate of fair value can be made; otherwise, at a later point in time, when such reasonable estimate of fair value can be made.

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143 The term *asset retirement obligation* refers to an obligation associated with the retirement of a tangible long-lived asset. The term *asset retirement cost* refers to the amount capitalized that increases the carrying amount of the long-lived asset when a liability for an asset retirement obligation is recognized. [FAS 143, footnote 1]

144 FAS 143, footnote 2; FAS 143, paragraph A6

145 FAS 143, Appendix C, Example 4; the "lease of land" for the exploitation of timber is not within the scope of FASB Statement No. 13. [FAS 13, paragraph 1]

146 FAS 13, paragraph 5(j)(i)

147 FAS 143, paragraph 17

148 FAS 143, paragraph A2

Instances in which asset retirement obligations are not reasonably estimable are expected to be rare. If a tangible long-lived asset with an existing asset retirement obligation is acquired, a liability for that obligation needs to be recognized at the asset's acquisition date as if that obligation were incurred on that date.[149]

The fair value of an asset retirement obligation is reasonably estimable if at least one of the following criteria is met:[150]

- It is evident that the fair value of the obligation is embodied in the acquisition price of the asset
- An active market exists for the transfer of the obligation
- Sufficient information exists to apply an expected present value technique

Upon recognition of an asset retirement obligation, a company capitalizes a corresponding asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability. That asset retirement cost is charged to expense over the asset's useful life, using a systematic and rational method.[151]

Subsequent to initial measurement, the fair value of the liability is adjusted to reflect changes resulting from:

- The passage of time, using the credit-adjusted risk-free rate that existed when the liability was initially measured
- Revisions to either the timing or the amount of the original estimate of undiscounted cash flows; upward revisions in the amount of undiscounted estimated cash flows are discounted using the current credit-adjusted risk-free rate, whereas downward revisions are discounted using the credit-adjusted risk-free rate that existed when the liability was originally recognized[152]

The increase in the fair value of an asset retirement obligation due to the passage of time constitutes operating expense; changes as a result of revisions to either the timing or the amount of the original estimate of cash flows that do not only affect the current period increase or decrease the carrying amount of the related long-lived asset.[153]

### Conditional Asset Retirement Obligations

Conditional asset retirement obligations are not conditional obligations. Rather, they are legal obligations to perform an asset retirement activity, with the timing and (or) method of settlement being conditional on a future event that may or may not be

149 FAS 143, footnote 4
150 FIN 47, paragraph 4
151 FAS 143, paragraph 11
152 FAS 143, paragraph 15
153 FAS 143, paragraphs 14 and 15

within the control of the entity.[154] As such, a liability needs to be recognized in the financial statements if the fair value can be reasonably estimated. When FIN 47, *Accounting for Conditional Asset Retirement Obligations,* became effective in 2005, many real estate companies recorded asset retirement obligations to reflect their legal obligations in connection with the removal of asbestos in their buildings.

| EXAMPLE—ASSET RETIREMENT OBLIGATION[155] |
|---|
| Store-4-U, Inc. (S) has acquired a fuel storage facility. A certain amount of spillage is inherent in the normal operations of the fuel storage facility. In the current period, improper operation resulted in a catastrophic accident that caused an unusual amount of spillage.<br>Is the environmental remediation liability that results from (1) the normal operations and/ or (2) from the accident within the scope of Statement 143?<br>The environmental remediation liability that results from the normal operations of the fuel storage facility is within the scope of Statement 143. Any obligation to remediate the spillage from the accident is not within the scope of Statement 143. However, S has to evaluate whether the recognition of an obligation to remediate the spillage is required by other authoritative guidance, such as SOP 96-1, *Environmental Remediation Liabilities*. |

DISCLOSURES

FASB Statement No. 143 requires the following disclosures:[156]

- A general description of the asset retirement obligations and the associated long-lived assets
- The fair value of assets that are legally restricted for purposes of settling asset retirement obligations
- A reconciliation of the beginning and ending aggregate carrying amount of asset retirement obligations, showing separately the changes attributable to (1) liabilities incurred in the current period, (2) liabilities settled in the current period, (3) accretion expense, and (4) revisions in estimated cash flows whenever there is a significant change

Additionally, in certain rare instances in which a company is not able to estimate the fair value of an asset retirement obligation, financial statement disclosures are required describing that circumstance and the company's reason for its inability to determine fair value.

***1.7.5.2 Environmental Remediation Liabilities*** For contamination that is outside of the scope of Statement 143, a company may nevertheless be required to recognize a liability under SOP 96-1, *Environmental Remediation Liabilities.* SOP

154 FIN 47, paragraph 3
155 Adapted from FASB Statement No. 143, paragraph A13
156 FAS 143, paragraph 22

96-1 provides accounting guidance for "environmental remediation liabilities that relate to pollution arising from some past act."[157]

A company's association with the site through past or present ownership or operation of a site, or the contribution or transportation of waste to a site, at which remedial actions (at a minimum, investigation) must take place may give rise to the recognition of an environmental remediation liability.[158]

Following the accounting guidance provided by FASB Statement No. 5, *Accounting for Contingencies*, a liability needs to be accrued if (1) information available prior to the issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements ("probability criterion") and (2) the amount of the loss can be reasonably estimated.[159]

#### Probability Criterion

Paragraph 108 of SOP 96-1 provides that in the context of environmental remediation liabilities, FASB Statement No. 5's probability criterion is met if both of the following elements are present on or before the date the financial statements are issued:

- It has been asserted (or it is probable that it will be asserted) that the entity is responsible for participating in a remediation process because of a past event.
- Based on available information, it is probable that the entity will be held responsible for participating in a remediation process because of that past event.

If litigation has commenced, a claim or an assessment has been asserted, or commencement of litigation or assertion of a claim or assessment is probable, and the company is associated with the site, there is a presumption that the outcome of the claim or assessment will be unfavorable.[160]

#### Ability to Reasonably Estimate the Liability

Once a company has determined that it is probable that an environmental remediation liability has been incurred, the company should estimate that liability based on available information. The estimate of the liability includes the company's (1) allocable share of the liability for a specific site, as well as its (2) share of amounts related to the site that will not be paid by other potentially responsible parties (PRPs) or the government.[161]

Due to the fact that environmental remediation is a complex process involving many steps, estimating the amount required to effect such remediation may

157 SOP 96-1, paragraph 99
158 SOP 96-1, paragraphs 107 and 109
159 SOP 96-1, paragraph 105
160 SOP 96-1, paragraph 109
161 SOP 96-1, paragraph 121

prove difficult. This is particularly true in the beginning stages of remediation.[162] The ability to reasonably estimate a *range of loss* is sufficient to meet the requirement for the recognition of an accrual in FASB Statement No. 5, assuming it is probable that an environmental remediation liability has been incurred.[163]

### Measurement

SOP 96-1 provides that ". . . the overall liability that is recorded may be based on amounts representing the lower end of a range of costs for some components of the liability and best estimates within ranges of costs of other components of the liability."[164] If various potentially responsible parties are involved, the amount to be recorded as a liability is based on the company's estimate of the share of the joint and several remediation liability that will ultimately be allocated to the company.[165]

Costs that should be included in determining the amount of liability are:[166]

1. Incremental direct costs of the remediation effort, such as:
   - Legal, engineering, and consulting fees
   - Costs related to completing the remedial investigation/feasibility study
   - Costs of contractors performing remedial actions
   - Government oversight costs
   - The cost of machinery and equipment dedicated to the remedial actions that do not have alternative uses
2. Costs of compensation and benefits for those employees who are expected to devote a significant amount of time directly to the remediation effort, to the extent of the time expected to be spent directly on the remediation effort. This may include technical employees who are involved with the remediation effort or internal legal staff dealing with remedial action.

The Accounting Standards Executive Committee (AcSEC) concluded that for purposes of measuring environmental remediation liabilities, the measurement should be based on enacted laws and adopted regulations and policies, rather than laws that are expected to be in force at a future point in time. The impact of changes in laws, regulations, and policies should be recognized when such changes are enacted or adopted.[167]

SOP 96-1 is more restrictive than Statement 143 as far as the discounting of the liability is concerned; it allows for discounting of the liability only, if

162 SOP 96-1, paragraph 110
163 SOP 96-1, paragraph 111; FIN 14, paragraph 3
164 SOP 96-1, paragraph 113
165 SOP 96-1, paragraph 133
166 SOP 96-1, paragraphs 124–127
167 SOP 96-1, paragraph 129

the aggregate amount of the liability or component and the amount and timing of cash payments for the liability or component are fixed or reliably determinable.[168] Entities that file with the SEC should follow the guidance in SEC Staff Accounting Bulletin (SAB) Topic 5Y.[169] That Staff Accounting Bulletin discusses the appropriate discount rate to be used: The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental liability could be settled in an arm's-length transaction with a third party.

#### Potential Recoveries

A company may expect to recover certain amounts expended for environmental remediation; for example, amounts may be recoverable from other potentially responsible parties, from the government, or from insurance companies. The amount of an environmental remediation liability should be determined independent from any potential claim for recovery, and an asset relating to any recovery should be recognized only when realization of the claim for recovery is deemed probable. If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.[170]

#### Presentation and Disclosure

Generally, environmental remediation–related expenses are included in operating expenses, because the events underlying the incurrence of the obligation relate to the operations of a company. Paragraph 149 of SOP 96-1 explains:

> Although charging the costs of remediating past environmental impacts against current operations may appear debatable because of the time between the contribution or transportation of waste materials containing hazardous substances to a site and the subsequent incurrence of remediation costs, environmental remediation–related expenses have become a regular cost of conducting economic activity. Accordingly, environmental remediation–related expenses should be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties should be reflected in the same income statement line. Any earnings on assets that are reflected on the entity's financial statements and are earmarked for funding its environmental liabilities should be reported as investment income.

Depending on the facts and circumstances, environmental remediation liabilities may be recorded on a discounted or undiscounted basis. APB Opinion No. 22, *Disclosure of Accounting Policies,* requires the disclosure of accounting

168 SOP 96-1, paragraph 132
169 SAB Topic 5Y, Question 1
170 SOP 96-1, paragraph 140

principles that materially affect the determination of financial position or results of operations, particularly where accounting alternatives exist. With respect to environmental remediation obligations, financial statements should disclose whether the accrual for environmental remediation liabilities is measured on a discounted or undiscounted basis.[171] SAB Topic 5Y also discusses disclosure requirements relating to liabilities for environmental remediation that are discounted and gives detailed examples of disclosures that may be necessary to prevent the financial statements from being misleading.[172]

Additionally, FASB Statement No. 5 requires certain disclosures for loss contingencies, including disclosures relating to the nature of accruals. If no accrual is recognized for environmental remediation because the criteria for recording a liability have not been met, the contingency needs to be disclosed when there is at least a reasonable possibility that a loss may have been incurred.[173] SOP 96-1 provides additional guidance relating to disclosures for environmental remediation loss contingencies.[174]

***1.7.5.3 Capitalizing versus Expensing of Environmental Remediation Costs*** Recording an environmental remediation liability usually results in a corresponding charge to income.[175] In certain limited situations, such as those listed below, it is appropriate to capitalize environmental remediation costs:

- Environmental treatment costs may be capitalized if one of the following criteria is met, assuming the costs are recoverable:[176]
  - The costs extend the life, increase the capacity, or improve the safety or efficiency of the property owned. For purposes of this criterion, the condition of the property after the costs are incurred must be improved as compared with the condition of the property when originally constructed or acquired.
  - The costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. In addition, the costs improve the property compared with its condition when constructed or acquired, if later.
  - The costs are incurred in preparing for sale property that is currently held for sale.
  - The costs are incurred for the removal of asbestos.[177]

171 SOP 96-1, paragraphs 151 and 152
172 SAB Topic 5Y, Question 1
173 FAS 5, paragraph 10; SOP 96-1, paragraph 155
174 SOP 96-1, paragraphs 155–169
175 SOP 96-1, paragraph 147
176 EITF Issue No. 90-8
177 EITF Issue No. 89-13

- In conjunction with the initial recording of a purchase business combination or the final estimate of a preacquisition contingency at the end of the allocation period following the guidance in FASB Statement No. 141, *Business Combinations,* an environmental liability is considered in the determination and allocation of the purchase price.[178]
- When recording the receipt of property received as a contribution, any environmental remediation liability associated with the contribution should be taken into consideration.[179]

EITF Issue No. 90-8 includes explicit examples with respect to the question of when it is appropriate to capitalize vs. expense costs to treat environmental contamination.

| EXAMPLE—COSTS TO TREAT ENVIRONMENTAL CONTAMINATION[180] |
| --- |
| Lead pipes in an office building owned by EnCo. contaminate the drinking water in the building. EnCo. removes the lead pipes and replaces them with copper pipes. Removing the lead pipes has improved the safety of the building's water system compared with its condition when the water system was built or acquired.<br>May EnCo. capitalize the replacement pipes?<br>Yes. EnCo. may capitalize the costs to remove the lead pipes and install copper pipes, because EnCo., as the owner of the water system, incurs costs to treat environmental contamination that improve the safety of the water system as compared with its condition when the building was acquired. The estimated book value of the lead pipes should be charged to expense at the time they are removed. |

**1.7.6 TRANSACTIONS WITH RELATED PARTIES** This section discusses three aspects of related party relationships:

- Financing provided by related parties
- Interest capitalization on investments accounted for under the equity method of accounting
- Purchase of real estate from a party that is under common control with the buyer

***1.7.6.1 Financing Provided by Related Parties*** As outlined in Section 1.2.2.5 of this chapter, interest cost incurred during the development and construction period of a real estate project is capitalized and becomes part of project costs. That includes interest cost incurred on financing provided by a parent company or affiliate. The related interest income to the parent or affiliate is deferred to the

178 SOP 96-1, paragraph 147
179 SOP 96-1, paragraph 147
180 Adapted from EITF Issue No. 90-8, Exhibit 90-8A, Example 4.

extent of any ownership interest in the project or in the company; in subsequent periods, such deferred interest income is amortized to offset the company's amortization of capitalized interest cost, if the building is used in the company's operations, or recognized into income upon sale of the real estate property.

If a real estate project is financed by a parent company that does not charge interest, no interest cost may be capitalized at the subsidiary level, since the subsidiary does not incur any interest cost.[181] The capitalization of interest is nevertheless appropriate at the *consolidated* level; the amount to be capitalized at the consolidated level is determined by following the four-step approach outlined in Section 1.2.2.5 of this chapter.

***1.7.6.2 Interest Capitalization on Investments Accounted for by the Equity Method*** Paragraph 9(c) of FASB Statement No. 34, *Capitalization of Interest Cost*, provides that assets qualifying for interest capitalization include investments (equity investments, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned operations, provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. Interest capitalization on investments in equity method investees is illustrated in more detail in Chapter 6 (Section 6.4.8).

***1.7.6.3 Purchase of Real Estate from Party under Common Control*** In real estate purchase transactions between unrelated parties, the purchaser of real estate generally records the real estate acquired at its purchase price. The purchase price represents the culmination of an arm's-length bargaining and presumably is reflective of the fair value of the real estate property. An exception to this general rule is the acquisition of property from a party that is under common control with the buyer; parties under common control do not bargain at arm's length, because the shareholders are essentially self-dealing. If companies under common control enter into transactions that are in the ordinary course of business, the agreed-upon purchase price is readily comparable to the price negotiated in similar transaction with unrelated parties. In these types of transactions, the purchaser would ordinarily not be precluded from recording property acquired at its purchase price, if it is reflective of the market price. However, because of the special characteristics of real estate, the purchase of real estate from a party under common control is generally not comparable to similar transactions with unrelated parties. A step-up in basis by the acquirer is therefore not considered appropriate;[182] rather, real estate purchased from an entity under common control is recorded at the transferor's

181 FAS 34, paragraph 15

182 Similarly, a seller is precluded by paragraph 34 of FASB Statement No. 66 to recognize profit from the sale of real estate to parties that are controlled by the seller.

carrying value, after write-down for impairment.[183] Any excess of consideration given over the transferor's carrying value is accounted for as a reduction in equity, often referred to as "dangling debit."[184] Authoritative literature does not address the accounting for "dangling debits." Companies account for a "dangling debit" in one of two ways. They:

1. Account for the dangling debit as a separate component of equity and reduce the "dangling debit" through depreciation charges over the life of the real estate (if the real estate is held for use in operations) or include the "dangling debit" in the cost of sale (when the property is sold to a third party).
2. Account for the "dangling debit" as capital distribution (disproportionate dividend to the controlling shareholder) with no further entries required in periods subsequent to property acquisition.

## 1.8 FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE

**1.8.1 CASH FLOW STATEMENT PRESENTATION** Pursuant to paragraph 15 of FASB Statement No. 95, *Statement of Cash Flows*, investing activities include "acquiring and disposing of . . . property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise . . ." Operating activities include all transactions and other events that are not defined as investing or financing activities, which generally involve producing and delivering goods and providing services.[185]

The classification of cash payments for real estate acquired or constructed depends on the intended use for the property. Cash paid to acquire or construct real estate that will be used as "productive asset," such as rental property, is classified as investing cash outflows. However, if land were acquired by a real estate developer to be subdivided and sold, any cash payments to purchase that real estate would be classified as operating cash flows; the real estate acquired is akin to inventory in other businesses.[186]

The three categories of operating, investing, and financing are not necessarily mutually exclusive, that is, alternative classifications are acceptable in certain situations.[187] For example, if an office building is being constructed that is intended for sale after it has been leased up, a question may arise whether that property

183 This is consistent with the guidance provided in paragraph D12 of FASB Statement No. 141, which states: "When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer."

184 This may not be the case in situations, in which equity instruments are issued as consideration for the real estate transferred.

185 FAS 95, paragraph 21

186 FAS 102, paragraph 24

187 FAS 95, paragraph 86

should be treated like inventory, with any cash payments to acquire and construct the asset being classified as operating cash flows, or whether it should be viewed as a productive asset, with any cash flows being classified as investing cash flow.

Paragraph 24 of Statement 95 provides that in instances in which a cash payment pertains to an item that could be considered either inventory or a productive asset, the appropriate classification should depend on the activity that is likely to be the predominant source of cash flows for the item.

**1.8.2 SEGMENT DISCLOSURES FOR PUBLIC COMPANIES** FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires that public companies report in their financial statements certain information about their reportable operating segments. Operating segments are "components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance."[188] Public real estate companies have to carefully evaluate whether they operate in different segments that have to be reported separately. For example, a homebuilder may segregate its business based on geographic region for internal reporting purposes. If information relating to geographic regions is regularly provided to the chief operating decision maker of the homebuilder, the homebuilder would likely be considered to have different operating segments.[189] In situations in which these operating segments do not have similar economic characteristics (e.g., they have dissimilar operating margin percentages or trends), they do not meet the criteria for segment aggregation in paragraph 17 of FASB Statement No. 131. In the year 2006, the SEC challenged the segment disclosures of public homebuilders and several companies restated their financial statements to report segment information based on regions of the country.

**1.8.3 OTHER PRESENTATION AND DISCLOSURE REQUIREMENTS** Presentation and disclosure requirements relating to real estate acquisition, development, and construction activities are included in FASB Statement No. 34, *Capitalization of Interest Cost*, with respect to the capitalization of interest cost, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, relating to intangible assets acquired in connection with the purchase of income producing properties.

188 FAS 131, Summary

189 Paragraph 13 of FASB Statement No. 131 describes a scenario in which an enterprise produces reports in which its business activities are presented in different ways. "If the chief operating decision maker uses more than one set of segment information, other factors may identify a single set of components as constituting an enterprise's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors."

### Disclosures Relating to the Capitalization of Interest

Paragraph 21 of FASB Statement No. 34 requires the following disclosures relating to interest cost, either in the income statement or in the notes to the financial statements:

- For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense
- For an accounting period in which interest cost is capitalized, the total amount of interest cost incurred during the period and the amount that has been capitalized

### Presentation and Disclosures Relating to the Acquisition of Intangibles

A company acquiring intangible assets (such as in-place leases in connection with the acquisition of income-producing properties) is subject to the financial statement presentation and disclosure requirements outlined in paragraphs 42 through 47 of Statement 142. Intangible assets need to be presented as a separate line item (or separate line items) in the balance sheet. Similarly, the aggregate amount of goodwill also needs to be presented as a separate line item in the balance sheet.[190]

Paragraph 44 of Statement 142 includes the following disclosure requirements in the period of acquisition:

- For intangible assets subject to amortization:
  - The total amount assigned and the amount assigned to any major intangible asset class
  - The amount of any significant residual value, in total and by major intangible asset class
  - The weighted-average amortization period, in total and by major intangible asset class
- For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class

Paragraph 45 of Statement 142 includes the following disclosure requirements for each period for which a balance sheet is presented:

- For intangible assets subject to amortization:
  - The gross carrying amount and accumulated amortization, in total and by major intangible asset class
  - The aggregate amortization expense for the period
  - The estimated aggregate amortization expense for each of the five succeeding fiscal years

190 FAS 142, paragraphs 42 and 43

- For intangible assets not subject to amortization, the total carrying amount and the carrying amount for each major intangible asset class
- The changes in the carrying amount of goodwill during the period, including:
  - The aggregate amount of goodwill acquired
  - The aggregate amount of impairment losses recognized
  - The amount of goodwill included in the gain or loss on disposal of all or a portion of a reporting unit

Companies that report segment information in accordance with FASB Statement No. 131 are required to provide the information about goodwill in total and for each reportable segment, as well as any significant changes in the allocation of goodwill by reportable segment. Additional disclosure requirements exist if a portion of the goodwill has not been allocated to a reporting unit.[191]

Additionally, FASB Statement No. 142 has specific disclosure requirements if a company recognizes an impairment loss related to intangible assets or goodwill.[192]

## 1.9 INTERNATIONAL FINANCIAL REPORTING STANDARDS

Two international accounting standards deal with property, plant, and equipment: International Accounting Standard (IAS) 40, *Investment Property*, which applies to real estate held for investment purposes, and IAS 16, *Property, Plant and Equipment*, which applies to all other types of tangible, long-lived assets.

**1.9.1 IAS 16** IAS 16 provides a comprehensive model that deals with the acquisition, development, and construction costs of property, plant and equipment, as well as with costs incurred subsequent to a property's acquisition or construction.

#### Recognition Criteria for Property, Plant, and Equipment[193]

An item of property, plant, and equipment is recognized as an asset only if the following criteria are met:

- It is probable that future economic benefits associated with the item will flow to the entity
- The cost of the item can be measured reliably

#### Initial Measurement of Property, Plant, and Equipment

Property, plant, and equipment that qualifies for recognition as an asset is measured at its cost, which is the amount of cash or cash equivalents paid and/or the

191 FAS 131, paragraph 45
192 FAS 142, paragraph 47
193 IAS 16, paragraph 7

fair value of other consideration given to acquire the asset at the time of acquisition or construction.[194] The recognition of costs ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management.

The cost of property, plant, and equipment is comprised of:[195]

- Purchase price
- Any costs directly attributable to bringing the asset to its location and condition necessary for it to be capable of operating in the manner intended by management, such as:
  - Costs of employee benefits arising directly from construction or acquisition
  - Costs of site preparation
  - Initial delivery and handling costs
  - Installation and assembly costs
  - Costs of testing
  - Professional fees
- Estimated costs of dismantling and removing the item and restoring the site on which it is located[196]

Examples of costs that are not capitalizable as part of the cost of the asset:[197]

- Costs of opening a new facility
- Costs of introducing a new product or service
- Costs of conducting business in a new location with a new class of customer
- Administrative and other general overhead costs
- Costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity
- Initial operating losses
- Costs of relocating or reorganizing part or all of an entity's operations

The cost of a *self-constructed asset* is determined by applying the same principles as for an acquired asset. If an entity produces similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale, which is addressed in IAS 2, *Inventories*.[198]

194 IAS 16, paragraph 6
195 IAS 16, paragraph 16
196 This is similar to the requirement under FASB Statement No. 143 to capitalize asset retirement cost.
197 IAS 16, paragraphs 19 and 20
198 IAS 16, paragraph 22

MEASUREMENT SUBSEQUENT TO INITIAL RECOGNITION

Two models exist for measuring property, plant, and equipment subsequent to initial recognition: (1) the cost model and (2) the revaluation model. The accounting policy a company selects—cost model or revaluation model—has to be applied to an entire asset class of property, plant, and equipment;[199] a company's assets of similar nature and use in its operations form an asset class. Land; land and buildings; furniture and fixtures; and office equipment are examples of separate classes.[200]

**Use of the Cost Model.** When using the cost model, property, plant, and equipment is carried at its cost less accumulated depreciation and any accumulated impairment losses.[201]

**Use of the Revaluation Model.** Assets whose fair value can be measured reliably may be accounted for using the revaluation model. Paragraph 31 of IAS 16 provides that under the revaluation model, property, plant, and equipment is carried at a revalued amount, which is its fair value at the date of revaluation less subsequent depreciation and impairment losses. To ensure that the carrying amount does not materially differ from that which would be determined using fair value at balance sheet date, revaluations have to be made with sufficient regularity. For items of property, plant, and equipment that experience significant changes in fair value, annual revaluations may be necessary; for other items that experience only insignificant changes in fair value, a revaluation every three to five years may be sufficient.[202] However, to avoid a selective revaluation of assets, a simultaneous revaluation of all of the assets of one class is required (or a revaluation of all of the items within a class on a rolling basis provided that the revaluation for the entire class is completed within a short period of time).[203]

If an asset's carrying amount is increased as a result of a revaluation, the increase is credited directly to equity (revaluation surplus), unless it reverses a revaluation decrease of the same asset previously recognized in profit or loss; in that case, any increase is recognized in profit or loss.[204] If an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognized in profit or loss, unless a credit balance exists in revaluation surplus with respect to that asset. In the case of a credit balance, the decrease is debited to equity (revaluation surplus).[205] Revaluation surplus relating to an asset is transferred to

199 IAS 16, paragraph 29
200 IAS 16, paragraph 37
201 IAS 16, paragraph 30
202 IAS 16, paragraph 34
203 IAS 16, paragraphs 36 and 38
204 IAS 16, paragraph 39
205 IAS 16, paragraph 40

retained earnings. The revaluation surplus can either be transferred to retained earnings when the asset is retired or disposed of or the revaluation surplus can be amortized to retained earnings as the asset is being depreciated. Paragraph 41 of IAS 16 explains: "In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss."

#### Costs Incurred Subsequent to Initial Recognition

IAS 16 also provides accounting guidance for costs incurred after the property has been placed in service. IAS 16 differentiates between day-to-day servicing and costs for the replacement of (other than small) parts of an asset. The costs of day-to-day servicing, which may include labor, consumables, and small parts, are expensed as incurred. The costs of a replacement of parts of an item of property, plant, and equipment are capitalized, assuming the recognition criteria outlined above are met. Any remaining carrying amount of the part replaced is derecognized.[206] Similarly, costs of major inspections, such as inspections for aircrafts, are capitalized as part of the asset as a replacement, if the recognition criteria for property, plant, and equipment are met. Any remaining carrying amount of a previous inspection is derecognized at that time.[207]

#### Disclosures

IAS 16 requires extensive disclosures for property, plant, and equipment, including the measurement bases used for determining the gross carrying amount; depreciation methods used; useful lives or depreciated rates used; and gross carrying amount and accumulated depreciation at the beginning and the end of the period together with a reconciliation.[208]

Additionally, paragraph 74 of IAS 16 requires the following disclosures:

- The existence and amounts of restrictions on title, and property, plant, and equipment pledged as security for liabilities
- The amount of expenditures recognized in the carrying amount of an item of property, plant, and equipment in the course of its construction
- The amount of contractual commitments for the acquisition of property, plant, and equipment
- If it is not disclosed separately on the face of the income statement, the amount of compensation from third parties for items of property, plant, and equipment that were impaired, lost, or given up that is included in profit or loss

206 IAS 16, paragraphs 12 and 13
207 IAS 16, paragraph 14
208 IAS 16, paragraph 73

For items of property, plant, and equipment that are stated at revalued amounts, the following disclosures are required:[209]

- The effective date of the revaluation
- Whether an independent valuer was involved
- The methods and significant assumptions applied in estimating the items' fair values
- The extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's-length terms or were estimated using other valuation techniques
- For each revalued class of property, plant, and equipment, the carrying amount that would have been recognized had the assets been carried under the cost model
- The revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders

### 1.9.2 IAS 40

#### Scope of IAS 40

IAS 40 provides accounting guidance for investment property. Investment property, which may be land, building, part of a building, or land and building, is defined as property held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for (1) use in the production or supply of goods or services or for administrative purposes or (2) sale in the ordinary course of business.[210]

Additionally, a lessee may classify and account for property leased under an operating lease as investment property, if the property otherwise meets the definition of investment property, and the lessee uses the fair value model (described below) for all other investment property it holds.[211]

Real estate property may by comprised of a portion that is held to earn rentals or for capital appreciation and another portion that is held for use in the production or supply of goods or services or for administrative purposes. Portions of "mixed-use" property are accounted for separately, if they could be sold or leased separately under finance leases; otherwise, "mixed-use" property is considered investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes.[212]

A property owner may provide ancillary services to occupants of a property. That property is classified as investment property if the ancillary services are

209 IAS 16, paragraph 77
210 IAS 40, paragraph 5
211 IAS 40, paragraph 6
212 IAS 40, paragraph 10

insignificant to the arrangement (for example, security and maintenance for office buildings). The property is not considered investment property if the ancillary services provided are significant to the arrangement, such as guest services in an owner-managed hotel.[213]

### Recognition Criteria for Investment Property[214]

The recognition criteria for investment property are the same as the recognition criteria for property, plant, and equipment under IAS 16. Investment property is recognized as an asset only if the following criteria are met:

- It is probable that the future economic benefits that are associated with the property will flow to the entity
- The cost of the investment property can be measured reliably

IAS 40 does not address the separate recognition of intangible assets—such as in-place leases and customer relationships—acquired in connection with the acquisition of investment property, which is required under U.S. GAAP;[215] The IASB is concerned about the "double-recognition" of assets, however. Paragraph 50 of IAS 40 provides, in part:

> In determining the fair value of investment property, an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities. For example:
>
> **(a)** Equipment such as lifts or air-conditioning is often an integral part of a building and is generally included in the fair value of the investment property, rather than recognized separately as property, plant, and equipment.
>
> **(b)** If an office is leased on a furnished basis, the fair value of the office generally includes the fair value of the furniture, because the rental income relates to the furnished office. When furniture is included in the fair value of investment property, an entity does not recognize that furniture as a separate asset.

### Initial Measurement of Investment Property

Initially, investment property is measured at its cost. The types of costs that are capitalizable are the same as those for property, plant, and equipment, discussed in Section 1.9.1 of this chapter. During the development and construction of property, IAS 16 applies. At the date of completion, the property becomes investment property, and IAS 40 becomes applicable.[216]

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213 IAS 40, paragraphs 11 and 12
214 IAS 40, paragraph 16
215 Discussed in Section 1.6 of this chapter.
216 IAS 40, paragraph 22

Any interest in property held by a lessee that is classified as investment property is initially recognized at the lower of the fair value of the property or the present value of minimum lease payments.[217]

#### Measurement after Initial Recognition

After initial recognition, IAS 40 provides a choice between two accounting models, the fair value model and the cost model. As a general rule, the accounting policy selected has to be applied to all of a company's investment properties.[218] There are three exceptions to this general rule:

1. A company may choose the fair value model or the cost model for "investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property."[219]
2. When a property interest held by a lessee under an operating lease is classified as investment property, the company has to apply the fair value model to all of its other investment property.[220]
3. If there is clear evidence at the time of acquisition that the fair value of the investment property will not be reliably determinable on a continuing basis, the company has to use the cost model.[221]

Under the fair value model, investment property is valued at fair value, with changes in fair value recognized in profit or loss.[222] The cost model follows the guidelines established in IAS 16 for measurement subsequent to initial recognition.[223] If the cost model is used, the fair value of investment property needs to be disclosed if it can be determined reliably, which is a rebuttable presumption pursuant to paragraph 53 of IAS 40.[224] Accordingly, companies that hold investment properties are generally required to determine the fair value of these properties, regardless of the accounting policy adopted.

IAS 40 allows for a change in accounting policy only if it leads to a more appropriate presentation; a change from the fair value model to the cost model will generally not satisfy that requirement.[225]

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217 IAS 40, paragraph 25
218 IAS 40, paragraph 30
219 IAS 40, paragraph 32A
220 IAS 40, paragraph 34
221 IAS 40, paragraph 53
222 IAS 40, paragraph 35
223 IAS 40, paragraph 56
224 IAS 40, paragraph 79(e); additional disclosures are required if a company cannot determine the fair value of the investment property reliably.
225 IAS 40, paragraph 31

### Costs Incurred Subsequent to Initial Recognition

Costs of day-to-day servicing are expensed as incurred.[226] Costs of replacing parts of an existing investment property, such as interior walls, are capitalized at the time of replacement. The parts that are being replaced are derecognized at that time.[227] Under the fair value model, the fair value of the investment property may already reflect that the parts that are being replaced have lost their value, or it may be difficult to determine by what amount to reduce the fair value of the property as a result of the derecognition of the replaced parts. When it is not practical to determine the amount by which the fair value of the property should be decreased, a company may include the cost of the replacement in the carrying amount of the asset and then reassess the fair value, as would be required for additions not involving replacements.[228]

### Change in Use

When a company uses the cost model, a transfer between investment property, owner-occupied property, and inventory does not impact the carrying amount of the property transferred.[229] A company that uses the fair value model accounts for a transfer between investment property, owner-occupied property, and inventory as follows:

- If a property carried at fair value is transferred from investment property to owner-occupied property or inventory, the property's fair value at the date of change in use is deemed to be its cost.[230]
- If owner-occupied property becomes investment property carried at fair value, any difference between the fair value and the carrying amount at the date of change in use is accounted for like a revaluation under IAS 16.[231]
- If inventory is transferred to investment property carried at fair value, any difference between the fair value of the property at the date of transfer and its previous carrying amount is recognized in profit and loss.[232]

### Disclosures

IAS 40 includes the following disclosure requirements:[233]

- Which model (the fair value model or the cost model) is applied
- If the fair value model is applied, whether, and in what circumstances, property interests held under operating leases are classified and accounted for as investment property

226 IAS 40, paragraph 63
227 IAS 40, paragraph 19
228 IAS 40, paragraph 68
229 IAS 40, paragraph 59
230 IAS 40, paragraph 60
231 IAS 40, paragraph 61
232 IAS 40, paragraph 63
233 IAS 40, paragraph 75

- When classification is difficult, the criteria used to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business
- The methods and significant assumptions applied in determining the fair value of investment property, including a statement whether the determination of fair value was supported by market evidence or was more heavily based on other factors because of the nature of the property and lack of comparable market data
- The extent to which the fair value of investment property is based on a valuation by an independent valuer who holds a relevant professional qualification and has requisite recent experience
- The amounts recognized in profit or loss for
  - Rental income from investment property
  - Direct operating expenses arising from investment property that generated rental income during the period
  - Direct operating expenses arising from investment property that did not generate rental income during the period
  - The cumulative change in fair value recognized in profit or loss on a sale of investment property from a pool of assets in which the cost model is used into a pool in which the fair value model is used[234]
- The existence and amounts of restrictions on the realizability of investment property or the remittance of income and proceeds of disposal
- Contractual obligations to purchase, construct, or develop investment property, or for repairs, maintenance, or enhancements

Additional disclosures are required by paragraphs 76 through 79 of IAS 40, depending on whether the cost or the fair value model is used.

## 1.10 SYNOPSIS OF AUTHORITATIVE LITERATURE

### FASB Statement No. 34, *Capitalization of Interest Cost*

FASB Statement No. 34 establishes standards for capitalizing interest cost as part of the historical cost of acquiring assets. To qualify for interest capitalization, assets must require a period of time to get them ready for their intended use. Interest capitalization on inventories that are routinely manufactured is not permitted.

234 Generally, a company either applies the fair value model or the cost model to its investment property. There is an exception to this general rule if a company has investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets, including that investment property. [IAS 40, paragraphs 30 and 32A]

### FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method,* an Amendment of FASB Statement No. 34

FASB Statement No. 58 amends FASB Statement No. 34 to limit capitalization of consolidated interest cost to qualifying assets of the parent company and consolidated subsidiaries and to include investments (equity, loans, and advances) accounted for by the equity method as qualifying assets of the investor while the investee has activities in progress necessary to commence its planned principal operations, provided that the investee's activities include the use of funds to acquire qualifying assets for its operations.

### FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants,* an amendment of FASB Statement No. 34

FASB Statement No. 62 amends FASB Statement No. 34 to require capitalization of interest cost of restricted tax-exempt borrowings less any interest earned on temporary investment of the proceeds of those borrowings from the date of borrowing until the specified qualifying assets acquired with those borrowings are ready for their intended use and to proscribe capitalization of interest cost on qualifying assets acquired using gifts or grants that are restricted by the donor or grantor to the acquisition of those assets.

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

FASB Statement No. 67 provides accounting guidance for the capitalization of costs associated with the acquisition, development, and construction of real estate projects and with the allocation of costs to individual components of a project. It also addresses the accounting for costs to sell or rent real estate projects.

### FASB Statement No. 141, *Business Combinations*

FASB Statement No. 141 addresses the financial accounting and reporting for business combinations. All business combinations within the scope of FASB Statement No. 141 must be accounted for using the purchase method.

### FASB Statement No. 141(revised 2007), *Business Combinations*

FASB Statement No. 141(R) replaces FASB Statement No. 141. FASB Statement No. 141(R) retains the requirement in FASB Statement No. 141, that the acquisition method of accounting (referred to as purchase method in FASB Statement No. 141) be used when accounting for business combinations. Significant changes to the provisions in FASB Statement No. 141 include the separate recognition of acquisition-related costs, measurement of the noncontrolling interest in the acquiree at fair value, recognition of assets acquired and liabilities assumed arising from contractual contingencies, and recognition of gain from a bargain purchase.

### FASB Statement No. 142, *Goodwill and Other Intangible Assets*

FASB Statement No. 142 addresses the financial accounting and reporting for acquired goodwill and other intangible assets. It provides guidance for the accounting of intangible assets that are acquired individually or with a group of other assets upon their acquisition. The Statement also addresses how goodwill and other intangible assets should be accounted for subsequent to their recognition in the financial statements.

### FASB Statement No. 143, *Accounting for Asset Retirement Obligations*

FASB Statement No. 143 provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, development, construction, and/or normal operation of long-lived assets, and for the associated asset retirement costs. FASB Statement No. 143 does not provide guidance for obligations of lessees in connection with leased property that meet the definition of either minimum lease payments or contingent rentals.

### FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*

FIN 47 clarifies that the term "conditional asset retirement obligation" as used in FASB Statement No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing and/ or method of settlement are conditional on a future event that may or may not be within the control of the company. FIN 47 also clarifies when a company would have sufficient information to reasonably estimate the fair value of an asset retirement obligation.

### EITF Issue No. 85-27, *Recognition of Receipts from Made-Up Rental Shortfalls*

**Issue.** A real estate developer sells a recently constructed office building to a syndication. For the payment of a fee, the developer enters into a master-leaseback arrangement with the seller, under which it leases the vacant space at a market rate for a two-year period. How should the syndication account for the fee it pays to the seller and the rent it receives from the seller?

**Consensus/Status.** The Task Force reached a consensus that payments to and receipts from the seller should be treated by the syndication as adjustments to the basis of the property. This consensus also applies to a property that is fully rented at the time of sale if the seller agrees to make up any decrease in rentals resulting from lease terminations during a specified period after the sale.

### EITF Issue No. 89-13, *Accounting for the Cost of Asbestos Removal*

A property owner may incur costs to remove or contain asbestos in compliance with federal, state, or local laws.

## Issues

1. Should the costs incurred to treat asbestos when a property with a known asbestos problem is acquired be capitalized or charged to expense?
2. Should the costs incurred to treat asbestos in an existing property be capitalized or charged to expense?
3. If it is deemed appropriate to charge asbestos treatment costs to expense, should they be reported as an extraordinary item?

**Consensuses/Status.** The Task Force reached the following consensuses:

1. Costs incurred to treat asbestos within a reasonable time period after a property with a known asbestos problem is acquired should be capitalized as part of the cost of the acquired property, subject to an impairment test.
2. Costs incurred to treat asbestos may be capitalized as a betterment subject to an impairment test for that property. When costs are incurred in anticipation of a sale, they should be deferred and recognized in the period of sale to the extent that the costs can be recovered from the estimated sales price.
3. Asbestos treatment costs that are charged to expense are not extraordinary items under Opinion 30.

The consensuses do not apply to asset retirement obligations that are within the scope of FASB Statement No. 143.

### EITF Issue No. 90-8, Capitalization of Costs to Treat Environmental Contamination

**Issue.** A company incurs costs to remove, contain, neutralize, or prevent existing or future environmental contamination. Should environmental contamination treatment costs be capitalized or expensed?

**Consensus/Status.** The Task Force reached a consensus that in general, environmental contamination treatment costs should be charged to expense. They may be capitalized if recoverable, but only if one of the following criteria is met:

1. The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company. The condition of the property after the costs are incurred must be improved as compared to the condition of the property when originally constructed or acquired.
2. The costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. In addition, the costs must improve the property compared with its condition when constructed or acquired.
3. The costs are incurred in preparing for sale property currently held for sale.

The consensus does not apply to obligations for environmental contamination treatment costs that are within the scope of FASB Statement No. 143.

EITF Issue No. 93-5, *Accounting for Environmental Liabilities*
Incorporated in and effectively nullified by SOP 96-1.

EITF Issue No. 95-23, *The Treatment of Certain Site Restoration/ Environmental Exit Costs When Testing a Long-Lived Asset for Impairment*
**Issue.** Should cash flows associated with environmental exit costs that may be incurred if a long-lived asset is sold, is abandoned, or ceases operations be included in the undiscounted expected future cash flows used to test a long-lived asset for recoverability under FASB Statement No. 144?

**Consensus/Status.** The Task Force reached a consensus that whether environmental exit costs should be included in the undiscounted expected future cash flows used to test a long-lived asset for recoverability under FASB Statement No. 144 depends on management's intent with respect to the asset. EITF Issue No. 95-23 provides examples for situations in which cash flows for environmental exit costs should be excluded from the FASB Statement No. 144 recoverability test.

EITF Issue No. 97-11, *Accounting for Internal Costs Relating to Real Estate Property Acquisitions*
**Issue.** Many companies incur internal costs related to a real estate property that are incurred for the purpose of, but prior to, obtaining that property. Can internal preacquisition costs be capitalized as part of the cost of a real estate property acquisition?

**Consensus/Status.** The Task Force reached a consensus that internal costs of preacquisition activities incurred in connection with the acquisition of a property that will be classified as nonoperating at the date of acquisition, that are directly identifiable with the acquired property, and that were incurred subsequent to the time that acquisition of that specific property was considered probable (that is, likely to occur) should be capitalized as part of the cost of that acquisition. If the entity subsequently determines that the property will be classified as operating at the date of acquisition, such costs should be charged to expense and any additional costs should be expensed as incurred.

Internal costs of preacquisition activities incurred in connection with the acquisition of a property that will be classified as operating at the date of acquisition should be expensed as incurred. If the entity subsequently determines that the property will be classified as nonoperating at the date of acquisition, previously expensed costs should not be capitalized as part of the cost of that acquisition.

### EITF Issue No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*

**Issue.** The EITF addresses how to determine whether an asset/asset group or a business has been acquired in a nonmonetary exchange. The guidance is equally applicable to the evaluation of whether productive assets or a business have been acquired in exchange for monetary consideration. How should a business be defined?

**Consensus/Status.** The EITF describes a business as a self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors. A business consists of (1) inputs, (2) processes applied to those inputs, and (3) resulting outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to conduct normal operations after the transferred set is separated from the transferor, which includes the ability to sustain a revenue stream by providing its outputs to customers.

The EITF includes a three-step process that should be followed in the evaluation of whether a business has been acquired.

FASB Statement No. 141(R), which is effective for annual reporting periods beginning on or after December 15, 2008, nullifies EITF Issue No. 98-3.

### EITF Issue No. 99-9, *Effect of Derivative Gains and Losses on the Capitalization of Interest*

**Issue.** Should the interest rate used in capitalizing interest pursuant to the provisions of FASB Statement No. 34 be the effective yield after gains and losses on the effective portion of a derivative instrument that qualifies as a fair-value hedge of the fixed interest rate date, or should it be the original effective rate of the fixed-rate debt?

**Consensus/Status.** The Task Force reached a consensus that amounts recorded in an entity's income statement as interest costs should be reflected in the capitalization rate under FASB Statement No. 34. Those amounts could include amortization of the adjustments of the carrying amount of the hedged liability if an entity elects to begin amortization of those adjustments during the period in which interest is eligible for capitalization. The ineffective portion of the fair-value hedge should not be reflected in the capitalization rate.

FASB Statement No. 133 prohibits the capitalization of the gain or loss on the hedging instrument in a cash-flow hedge. The FASB Staff believes that, when the variable-rate interest on a specific borrowing is associated with an asset under construction and capitalized as a cost of that asset, the amounts in accumulated comprehensive income related to a cash-flow hedge of the variability of that interest should be reclassified into earnings over the depreciable life of the constructed asset, since that depreciable life coincides with the amortization period for the capitalized interest cost on the debt.

EITF Issue No. 02-17, *Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination*

**Issues.** FASB Statement No. 141 requires that intangible assets be recorded apart from goodwill, if they arise from contractual or legal rights (the contractual-legal criterion), or if they are capable of being separated or divided from the acquired entity (the separability criterion). The EITF addresses three issues relating to the application of FASB Statement No. 141.

**Consensus/Status.** The Task Force reached consensuses, and the EITF Abstract includes examples of the application of these consensuses.

EITF Issue No. 03-9, *Determination of the Useful Life of Renewable Intangible Assets under FASB Statement No. 142, Goodwill and Other Intangible Assets*

**Issues.** Four issues are addressed in that EITF Abstract, relating to the determination of the useful life of intangible assets (Issues 1 through 3) and to the recognition of an intangible asset apart from goodwill (Issue 4).

**Consensuses/Status.** No consensuses were reached. EITF Issue No. 03-9 was removed from the EITF agenda. At the recommendation of the Task Force, the FASB added this issue to the FASB agenda and has issued proposed FSP FAS 142F.

EITF Issue No. 03-17, *Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet*

**Issues.** The issues are:

1. What is the appropriate amortization of an asset arising from an executory contract?
2. What is the appropriate method of derecognition for a balance sheet credit arising from an executory contract?

**Consensuses/Status.** The issue has been removed from the EITF agenda.

EITF Issue No. 04-1, *Accounting for Preexisting Relationships between the Parties to a Business Combination*

**Issues.** The EITF addresses the accounting for pre-existing relationships between the parties to a business combination. The issues are:

1. Should a business combination between two parties that have a pre-existing relationship be evaluated to determine if a settlement of a pre-existing relationship exists, thus requiring accounting separate from the business combination?
2. How should the effective settlement of an executory contract in a business combination be measured?
3. Should the acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized

intangible assets be included in the measurement of the settlement amount or included as part of the business combination?

4. Should the acquirer recognize, apart from goodwill, an acquired entity's intangible asset(s) that, before the business combination, arose solely from the acquired entity's right to use the acquirer's intangible asset(s)?
5. Is it appropriate for an acquirer to recognize a settlement gain in conjunction with the effective settlement of a lawsuit or an executory contract in a business combination?

**Consensuses/Status.** The Task Force reached the following consensuses:

1. Consummation of a business combination between parties with a pre-existing relationship should be evaluated to determine if a settlement of a pre-existing relationship exists. A business combination between two parties that have a pre-existing relationship is a multiple-element transaction, with one element being the business combination and the other element being the settlement of the pre-existing relationship.
2. The effective settlement of an executory contract in a business combination as a result of a pre-existing relationship should be measured at the lesser of:
   a. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared to pricing for current market transactions for the same or similar items
   b. Any stated settlement provisions in the contract available to the counterparty to which the contract is unfavorable
3. The acquisition of a right that the acquirer had previously granted to the acquired entity to use the acquirer's recognized or unrecognized intangible assets should be included as part of the business combination. If the contract granting such right is favorable or unfavorable when compared to current market transactions, a settlement gain or loss should be recognized, measured based on the consensus reached in Issue 2.
4. A reacquired right should be recognized as an intangible asset apart from goodwill.
5. A settlement gain or loss should be recognized in conjunction with the effective settlement of a lawsuit or executory contract in a business combination.

### EITF Issue No. 04-2, *Whether Mineral Rights Are Tangible or Intangible Assets*

**Issues.** The issues are:

1. Are mineral rights tangible or intangible assets?
2. If mineral rights are intangible assets, are mineral rights finite-lived or indefinite-lived intangible assets?

### Consensuses/Status

1. The Task Force reached a consensus that mineral rights are tangible assets, the aggregate carrying amount of which should be reported as separate component of property, plant, and equipment either on the face of the financial statements or in the notes to the financial statements.
2. As a result of the consensus reached on Issue 1, the Task Force did not discuss Issue 2.

EITF TOPIC NO. D-108, *USE OF THE RESIDUAL METHOD TO VALUE ACQUIRED ASSETS OTHER THAN GOODWILL*

FASB Statement No. 141 requires that intangible assets that meet the recognition criteria be recorded at fair value. The SEC staff does not believe that the application of the residual method to the valuation of intangible assets can be assumed to produce amounts representing the fair values of those assets. Accordingly, the SEC staff believes that a direct value method, rather than the residual method, should be used to determine the fair value of all intangible assets other than goodwill.

AICPA STATEMENT OF POSITION 93-7, *REPORTING ON ADVERTISING COSTS*

SOP 93-7 provides guidance on the accounting, reporting, and disclosure of advertising costs in financial statements. It requires that the costs of advertising be expensed either as incurred or at the first time the advertising takes place, except for direct-response advertising (1) whose primary purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising and (2) that results in probable future economic benefits. For direct-response advertising that may result in reported assets, the SOP addresses how such assets should be measured initially, how the amounts ascribed to such assets should be amortized, and how the realizability of such assets should be assessed.

AICPA STATEMENT OF POSITION 96-1, *ENVIRONMENTAL REMEDIATION LIABILITIES*

SOP 96-1 is divided into two parts. Part 1 provides an overview of key environmental laws and regulations. Part 2 provides guidance on the accounting, presentation and disclosure of environmental remediation liabilities that relate to pollution arising from some past act, generally as a result of the provisions of Superfund, the corrective-action provisions of the Resource Conservation and Recovery Act, or analogous state and non-U.S. laws and regulations. Following the general guidance of FASB Statement No. 5, SOP 96-1 provides that a liability be accrued if (1) it is probable that an asset has been impaired or a liability has been incurred and (2) the amount of the loss can be reasonably estimated. For purposes of measuring environmental remediation liabilities, the measurement should be based on enacted laws and adopted regulations and policies. Discounting the liability to reflect the time value of money is considered appropriate only if certain conditions are met.

If there is more than one party involved, SOP 96-1 provides that the environmental remediation liability recorded by a company should be based on an estimate of the company's allocable share of the joint and several remediation liability. The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery should be recognized only when realization of the claim for recovery is deemed probable.

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

SOP 98-5 provides guidance on the financial reporting of start-up costs and organization costs; the costs of start-up activities and organization costs are to be expensed as incurred. The SOP defines start-up activities as one-time activities relating to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with a new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operation. Start-up activities include activities related to organizing a new entity (organization costs).

### AICPA Proposed Statement of Position, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*

The proposed SOP provides guidance on accounting for property, plant, and equipment, which is based on the following principles:

- Property, plant, and equipment consists of one or more components, which should be recorded at cost.
- A component of property, plant, and equipment should be depreciated over its expected useful life.
- The costs of a replacement property, plant, and equipment component replaced should not concurrently be recorded as assets.

### SEC Staff Accounting Bulletin Topic 5Y[235], *Accounting and Disclosures Relating to Loss Contingencies*

SAB Topic 5Y addresses the following questions:

1. What discount rate should be used to determine the present value of an environmental remediation or product liability that meets the conditions for recognition on a discounted basis in SOP 96-1, and what special disclosures are required in the notes to the financial statements?
2. What financial statement disclosures should be furnished with respect to recorded and unrecorded product or environmental remediation liabilities?

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3. What disclosures regarding loss contingencies may be necessary outside the financial statements?
4. What disclosures should be furnished with respect to site restoration costs or other environmental remediation costs?

Interpretive Responses:

1. The rate used to discount the cash payments should be the rate that will produce an amount at which the environmental or product liability could be settled in an arm's-length transaction with a third party.
2. Typically, product and environmental remediation liabilities are of such significance that detailed disclosures regarding the judgments and assumptions underlying the recognition and measurement of the liabilities are necessary to prevent the financial statements from being misleading and to inform readers fully regarding the range of reasonably possible outcomes that could have a material effect on the registrant's financial condition, results of operations, or liquidity.
3. Registrants should consider Items 101 (Description of Business), 103 (Legal Proceedings), and 303 (MD&A) of Regulations S-K and S-B. The Commission has issued interpretive releases that provide additional guidance with respect to these items.
4. Material liabilities for site restoration, post-closure, and monitoring commitments, or other exit costs that may occur on the sale, disposal, or abandonment of a property as a result of unanticipated contamination of the asset should be disclosed in the notes to the financial statements.

SEC Staff Accounting Bulletin Topic 10F, Presentation of Liabilities for Environmental Costs

SAB Topic 10F addresses questions relating to rate-regulated enterprises' recognition and presentation of liabilities for environmental costs.

International Accounting Standard 16, Property, Plant, and Equipment

IAS 16 prescribes the accounting for property, plant, and equipment, including their recognition, measurement, and derecognition; it provides guidance with respect to depreciation charges and impairment losses, and disclosures relating to property, plant, and equipment. The Standard allows for the use of the cost model or the revaluation model.

International Accounting Standard 40, Investment Property

IAS 40 prescribes the accounting—and related disclosures—for investment property, that is, real estate property held by the owner or by the lessee under a finance lease to earn rentals or for capital appreciation or both, rather than for (1) use in the production or supply of goods or services or for administrative purposes; or (2) sale in the ordinary course of business.