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**Accounting for costs to sell and rent, and initial rental operations of, real estate projects, a proposed recommendation to the Financial Accounting Standards Board; Statement of position 78-03;**

American Institute of Certified Public Accountants. Accounting Standards Division

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**Statement of  
Position**  
on

**78-3**

**Accounting for  
Costs to Sell and Rent,  
and Initial Rental Operations  
of, Real Estate Projects**

**June 30, 1978**

**A Proposed Recommendation to the  
Financial Accounting Standards Board**

**Issued by  
Accounting Standards Division**

**American Institute of  
Certified Public Accountants**

**AICPA**

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## **NOTE**

Statements of position of the AICPA accounting standards division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of statements of position is to influence the development of accounting and reporting standards in directions the division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, statements of position do not establish standards enforceable under the Institute's code of professional ethics.

June 30, 1978

Donald J. Kirk, CPA  
Chairman  
Financial Accounting Standards Board  
High Ridge Park  
Stamford, Connecticut 06905

Dear Mr. Kirk:

The accompanying draft of the statement of position, Accounting for Costs to Sell and Rent, and Initial Rental Operations of, Real Estate Projects, has been prepared on behalf of the accounting standards division by the AICPA committee on real estate accounting and approved by the accounting standards executive committee.

The statement presents the division's recommendations on accounting for costs to sell and costs to rent real estate projects during their selling or renting phases. It also presents the division's recommendations on accounting for costs and revenues during the initial operating period of a rental project—the period before occupancy stabilizes (sometimes referred to as the "rent-up" period).

Representatives of the division are available to discuss this proposal with you or your representatives at your convenience.

Sincerely,



Arthur R. Wyatt, Chairman  
Accounting Standards Division

cc: Securities and Exchange Commission

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# Accounting for Costs to Sell or Rent, and Initial Rental Operations of, Real Estate Projects

The accounting standards division has noted that diverse practices are followed in accounting for both costs to sell and costs to rent real estate projects. It has also noted that diverse practices are followed in accounting for costs and revenues during the initial operating period of a rental project, before occupancy stabilizes (sometimes referred to as the “rent-up” period). The division believes that narrowing the range of those practices is desirable. This statement of position sets forth the division’s recommendations on accounting for costs to sell and costs to rent real estate projects and for initial rental operations of such projects.

This statement does not apply to—

- Accounting for depreciation, carrying costs, or operations of real estate projects being accounted for as held for sale.
- “Initial direct costs” (as defined in FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*) of sales-type, operating, and other types of leases, the accounting for which is prescribed in FASB Statement no. 13.
- Costs directly related to manufacturing, merchandising, or service activities (“commercial activities”) as distinguished from real estate activities.
- Real estate rental activity in which the predominant rental period is less than one month.

This statement does not modify the accounting methods for retail land sale companies as prescribed in the AICPA industry accounting guide, *Accounting for Retail Land Sales*.

In the absence of contrary evidence, the representations of the owners of a real estate project concerning whether the project is held for sale or held for rental should govern the accounting for the project under the provisions of this statement. If the owners represent that a portion of a real estate project will be held for sale and a portion will be held for rental, the costs of the project should be allocated to the two portions, each of which should be accounted for as a separate project. An example of such a project would be a building with commercial facilities held for rental on its lower floors and condominium units held for sale on its upper floors. If any portion of a real estate project that the owners represented as being held for sale is rented and the rental is not clearly incidental or temporary, the unsold portion of the project should be accounted for as being held for rental.

## **Costs Incurred to Sell Real Estate Projects**

### ***Present Practices***

Costs to sell real estate projects are accounted for in one or more of the following ways:

1. As project costs, which are capitalized as part of construction costs.
2. As prepaid expenses or deferred charges, which are deferred and amortized over future periods.
3. As period costs, which are charged to expenses as they are incurred.

The criteria governing the selection of those methods vary among companies.

### ***Recommended Practices***

The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods described above and provide examples of the application of those criteria.

*Project Costs.* Costs to sell real estate projects, less amounts recovered from incidental operations or sales, should be classified with, and accounted for in the same manner as, construction costs if they meet both of the following criteria:<sup>1</sup>

1. The costs are incurred (a) for tangible assets that are used directly throughout the selling period to aid in the sale of the project or (b) for services that have been performed to obtain regulatory approval for sales.
2. The costs are reasonably expected to be recovered from sales of the project or from incidental operations.

Examples of costs that ordinarily meet the criteria for project costs include the costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semipermanent signs.

*Prepaid Expenses.* Costs to sell real estate projects should be accounted for as prepaid expenses if they (1) do not meet the criteria for project costs and (2) are incurred for goods or services before the goods are used or before the services are performed. Examples of costs that ordinarily meet the criteria for prepaid expenses include costs of future advertising, unused selling brochures, and commission advances. Prepaid expenses that are identifiable with specific future revenue should be charged to expenses in the periods in which the related revenue is recognized as earned. Prepaid expenses that are associated with future periods but not with specific future revenue should be charged to expenses in the periods of expected benefit.

*Period Costs.* Costs to sell real estate projects that do not meet the criteria for project costs or prepaid expenses should be accounted for as period costs and charged to expenses as incurred. The benefit of those costs usually is limited to the period in which they are incurred; such costs usually provide little discernible future benefits. Examples of costs that should

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<sup>1</sup> For purposes of this statement, costs to sell real estate projects do not include the costs of amenities, such as golf courses and marinas.



be accounted for as period costs include costs of advertising that have appeared in the media, sales salaries and sales overhead, and “grand openings.”

## **Costs Incurred to Rent Real Estate Projects**

### ***Present Practices***

At present, costs to rent real estate projects under operating leases may be deferred to future periods or charged to expenses as incurred. Generally accepted criteria to govern the choice between the two methods have not been established.

### ***Recommended Practices***

The following paragraphs set forth recommended criteria within the framework of present generally accepted accounting principles (see the appendix to this statement for selected accounting literature) to govern the selection of the methods used to account for costs to rent real estate projects under operating leases and provide examples of the application of those criteria.

*Rental Costs Chargeable to Future Periods.* Costs to rent real estate projects under operating leases should be deferred and charged to expenses in future periods if they are incurred for goods or services before the goods are used or before the services are performed or if they are associated with, and their recovery is reasonably expected from, future rental operations.<sup>2</sup> Such costs should be classified in accordance with the nature of the expenditure. Examples of costs that ordinarily should be deferred and charged to expenses in future periods include costs of model units and their furnishings, rental facilities, semipermanent signs, and unused rental brochures.

Deferred rental costs that are directly related to revenue from a specific operating lease should be amortized over the lease term. Deferred rental costs that are not directly related to revenue from a specific operating lease should be amortized to expenses over the period of expected benefit; the period of

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<sup>2</sup> For the purposes of this statement, costs to rent real estate projects do not include the costs of amenities, such as golf courses and marinas.

amortization should begin when the project is substantially completed and held available for occupancy. Estimated unrecoverable amounts of unamortized deferred rental costs associated with a lease or group of leases should be charged to expenses when it becomes probable that the leases will be terminated.

*Rental Costs Chargeable to the Current Period.* Costs to rent real estate projects that do not meet the criteria for rental costs chargeable to future periods should be accounted for as period costs and charged to expenses as incurred. Examples of costs that should be accounted for as period costs include costs of advertising that has appeared in the media, rental salaries and rental overhead, and “grand openings.”

## **Initial Rental Operations**

### ***Present Practices***

As previously noted, companies follow diverse practices in accounting for costs and revenues during the initial operating period of a rental project. Some consider the initial operating period to extend until a project has reached a predetermined level of occupancy, others, until certain events take place (for example, until the owners obtain permanent financing), and others, until the end of a specified period.

Some companies follow the practices of capitalizing carrying costs and operating expenses net of revenues and of not recording depreciation, or of capitalizing depreciation that is recorded, until the end of the initial operating period as variously defined. They believe that reporting operating losses during the initial operating period is not appropriate when such losses are anticipated and are reasonably expected to be recovered from future rental operations.

Others follow the practice of capitalizing carrying costs and operating expenses only until a rental project is capable of producing revenues and then begin recording carrying costs, depreciation, and operating expenses in operations. They believe that the rental, occupancy status, or age of a rental project should not affect the accounting for the results of operations. They believe that the operating period starts for accounting

purposes once a rental project is substantially completed and held available for occupancy or is actually occupied.

### **Recommended Practices**

Certain costs incurred during construction, before a rental project is capable of producing revenue, may be capitalized, and that practice is supported by ample precedents. However, once major construction activity is completed and the project is capable of producing revenue, a rental project should be considered substantially completed and held available for occupancy. The accounting standards division believes that at that stage a change in the status of the rental project has taken place and that the owner's principal activities are substantially different from those during the construction period. Therefore, the accounting for costs and revenues should reflect the change in status of the project, as set forth in the following paragraphs.

For purposes of this statement, a rental project is "substantially completed and held available for occupancy" if it meets both of the following conditions:

1. Construction has reached the stage of completion at which the builder originally intended to cease major construction activity, as distinguished from activity such as routine maintenance and cleanup.
2. Units are being or have been offered for rental.

Portions of a rental project may be substantially completed and occupied by tenants or held available for occupancy, and other portions may not have reached that stage. Under those circumstances, costs incurred should be allocated between the portions under construction and the portions substantially completed and held available for occupancy, and each portion should be accounted for as a separate project.<sup>3</sup>

Construction activity on a rental project may be suspended before the entire project is substantially completed and held available for occupancy for reasons such as insufficient rental

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<sup>3</sup> A portion of a rental project accounted for as a separate project is "a rental project" for the purpose of this statement.

demand. Conditions such as insufficient rental demand may indicate an impairment of the carrying value of a project that is other than temporary, whether or not they lead to suspension of construction. If it is concluded that such an impairment has occurred, an appropriate provision for losses should be recorded. Also, suspension of construction because of insufficient rental demand should, in the event carrying costs are being capitalized, cause a reevaluation of that accounting policy.

The accounting standards division believes that, for a rental project that is substantially completed and held available for occupancy, rental revenues and operating costs should be recorded in income and expenses as they accrue. Amortization of costs to rent the project should be recorded in accordance with the recommendations in the section of this statement on rental costs chargeable to future periods.

A minority of the accounting standards executive committee believes depreciation charges for a rental project that is substantially completed and held available for occupancy should be based on the greater of (1) the portion of the project that is actually rented or otherwise occupied or (2) the portion of the project that the owner anticipated would be rented based on his original projection for rental achievement. However, in the absence of persuasive evidence to the contrary, depreciation should be provided for the total rental project no later than two years following the date the rental project becomes substantially completed and held available for occupancy. The minority believes that the occupancy status of a rental project is an important factor in accounting for depreciation and that the advocated method of phasing in depreciation based on occupancy status results in a proper matching of cost and revenue as anticipated at the rental project's inception.

The accounting standards division believes the useful life of a rental project begins to expire when it is substantially completed and held available for occupancy. Accordingly, at such time, depreciation on the cost of the entire project should be provided by charges to expenses.

The division believes that, because of the project's changed status, all carrying costs applicable to the project, such as real estate taxes, should be charged to expense once a project is substantially completed and held available for occupancy.

## **Transition**

The division recommends the application of the provisions of this statement on a prospective basis to costs to sell and costs to rent real estate projects incurred during fiscal years beginning after June 30, 1978, and for initial rental operations for projects that become substantially completed and held available for occupancy during fiscal years beginning after June 30, 1978. Earlier application is encouraged for fiscal years beginning before July 1, 1978, for which financial statements have not been issued.

## APPENDIX

### Selected Accounting Literature

The three pervasive expense recognition principles are discussed in paragraphs 155 and 156 of Accounting Principles Board Statement no. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*:

Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets. Costs associated with past revenue or otherwise associated with prior periods are adjustments of the expenses of those prior periods. The expenses of a period are (a) costs directly associated with the revenue of the period, (b) costs associated with the period on some basis other than a direct relationship with revenue, and (c) costs that cannot, as a practical matter, be associated with any other period.

Three pervasive expense recognition principles specify the bases for recognizing the expenses that are deducted from revenue to determine the net income or loss of a period. They are "associating cause and effect," "systematic and rational allocation," and "immediate recognition."

Paragraph 161 of Accounting Principles Board Statement no. 4 discusses the application of expense recognition principles:

To apply expense recognition principles, costs are analyzed to see whether they can be associated with revenue on the basis of cause and effect. If not, systematic and rational allocation is attempted. If neither cause and effect associations nor systematic and rational allocations can be made, costs are recognized as expenses in the period incurred or in which a loss is discerned. Practical measurement difficulties and consistency of treatment over time are important factors in determining the appropriate expense recognition principle.

Associating cause and effect (often referred to as the "matching" process) is commented on in paragraph 157 of Accounting Principles Board Statement no. 4:

Although direct cause and effect relationships can seldom be conclusively demonstrated, many costs appear to be related to particular revenue and recognizing them as expenses accompanies recognition of the revenue. Examples of expenses that are recognized by associating cause and effect are sales commissions and costs of products sold or services provided.

Paragraphs 159 and 160 of Accounting Principles Board Statement no. 4 discuss the procedures followed in the absence of a presumed direct association with specific revenue:

If an asset provides benefits for several periods, its cost is allocated to the periods in a systematic and rational manner in the absence of a more direct basis for associating cause and effect. The cost of an asset that provides benefits for only one period is recognized as an expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumptions about the pattern of benefits and the relationship between costs and benefits because neither of these two factors can be conclusively demonstrated. The allocation method used should appear reasonable to an unbiased observer and should be followed systematically. Examples of items that are recognized in a systematic and rational manner are depreciation of fixed assets, amortization of intangible assets, and allocation of rent and insurance. Systematic and rational allocation of costs may increase assets as product costs or as other asset costs rather than increase expenses immediately, for example, depreciation charged to inventory and costs of self-constructed assets. These costs are later recognized as expenses under the expense recognition principles.

[The immediate recognition] principle of expense recognition results in charging many costs to expense in the period in which they are paid or liabilities to pay them accrue. Examples include officers' salaries, most selling costs, amounts paid to settle lawsuits, and costs of resources used in unsuccessful efforts. The principle of immediate recognition also requires that items carried as assets in prior periods that are discovered to have no discernible future benefit be charged to expense, for example, a patent that is determined to be worthless.

The term "initial direct costs" is defined in paragraph 8 of FASB Statement no. 17, *Accounting for Leases—Initial Direct Costs*, as follows:

[Initial direct costs are] those costs incurred by the lessor that are directly associated with negotiating and consummating completed leasing transactions. Those costs include, but are not necessarily limited to, commissions, legal fees, costs of credit investigations, and costs of preparing and processing documents for new leases acquired. In addition, that portion of salespersons' compensation, other than commissions, and the compensation of other employees that is applicable to the time spent in the activities described above with respect to completed leasing transactions shall also be included in initial direct costs. That portion of salespersons' compensation and the compensation of other employees that is applicable to the time spent in negotiating leases that are not consummated shall not be included in initial direct costs. No portion of supervisory and administrative expenses or other indirect expenses, such as rent and facilities costs, shall be included in initial direct costs.

Paragraph 17(c) of FASB Statement no. 13, *Accounting for Leases*, requires that lessors account for “initial direct costs” of sales-type leases as follows:

The present value of the minimum lease payments (net of executory costs, including any profit thereon), computed at the interest rate implicit in the lease, shall be recorded as the sales price. The cost or carrying amount, if different, of the leased property, plus any initial direct costs (as defined in paragraph 5 (m)), less the present value of the unguaranteed residual value accruing to the benefit of the lessor, computed at the interest rate implicit in the lease, shall be charged against income in the same period.

Paragraph 18(b) of FASB Statement no. 13 requires that lessors account for “initial direct costs” of direct financing leases as follows:

The difference between the gross investment in the lease in (a) above and the cost or carrying amount, if different, of the leased property shall be recorded as unearned income. The net investment in the lease shall consist of the gross investment less the unearned income. Initial direct costs (as defined in paragraph 5 (m)) shall be charged against income as incurred, and a portion of the unearned income equal to the initial direct costs shall be recognized as income in the same period. The remaining unearned income shall be amortized to income over the lease term so as to produce a constant periodic rate of return on the net investment in the lease. However, other methods of income recognition may be used if the results obtained are not materially different from those which would result from the prescribed method in the preceding sentence. The net investment in the lease shall be subject to the same considerations as other assets in classification as current or noncurrent assets in a classified balance sheet. Contingent rentals, including rentals based on variables such as the prime interest rate, shall be credited to income when they become receivable.

Paragraph 19(c) of FASB Statement no. 13 requires that lessors account for “initial direct costs” of operating leases as follows:

Initial direct costs shall be deferred and allocated over the lease term in proportion to the recognition of rental income. However, initial direct costs may be charged to expense as incurred if the effect is not materially different from that which would have resulted from the use of the method prescribed in the preceding sentence.

The relationship of depreciation to useful lives, and the nature of depreciation as an allocation process, not a valuation process, is noted in the definition offered in paragraph 56 of the AICPA’s *Accounting Terminology Bulletin no. 1, Review and Resumé* (1953).



*Depreciation accounting* is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. . . .

Depreciation of a productive facility is described as follows in paragraph 5 of chapter 9C, Accounting Research Bulletin no. 43, *Emergency Facilities—Depreciation and Amortization*.

The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.

Accounting Research Monograph no. 1, *Accounting for Depreciable Assets*,<sup>4</sup> suggests implementing criteria relative to useful life for depreciation purposes:

The estimate of "useful life" encompasses that span of time beginning after an asset is ready for use and begins to benefit the company significantly *or* when its ability to benefit the company begins to expire, and ending when the asset no longer benefits the company significantly *or* when its ability to benefit the company expires.

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<sup>4</sup> Charles W. Lambden, Dale L. Gerboth, and Thomas W. McRae, *Accounting for Depreciable Assets*, Accounting Research Monograph no. 1 (New York: AICPA, 1975), pp. 76-77.