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Accounting for costs to sell and rent, and initial rental operations of, real estate projects; Exposure draft (American Institute of Certified Public Accountants), 1977, Aug. 1

American Institute of Certified Public Accountants. Real Estate Accounting Committee

ACCOUNTING FOR COSTS TO SELL AND RENT, AND INITIAL RENTAL OPERATIONS OF, REAL ESTATE PROJECTS

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

This exposure draft has been prepared for public comment by the Committee on Real Estate Accounting of the Accounting Standards Division, American Institute of Certified Public Accountants. It is being distributed to Members of Council of the AICPA; Members of Technical Executive Committees of the AICPA; State Society Presidents and Executive Directors; Chairmen of State Society Committees on Accounting Practices; and certain organizations outside the accounting profession. Copies are available to interested persons and organizations on request.

Comments should be sent in time to arrive not later than October 30, 1977 to

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To Persons and Organizations Interested in Accounting for Investments in Real Estate Ventures:

The accompanying exposure draft has been prepared by the Committee on Real Estate Accounting of the AICPA's Accounting Standards Division to obtain the comments of interested persons and organizations. It is intended to help focus attention on the issues considered and foster the interchange of ideas among those interested in improving accounting and reporting standards.

The Committee urges respondents to give particular attention to the three alternative approaches to accounting for depreciation and carrying costs on a rental project during the period of initial operations as described in paragraphs 23 through 26 of the exposure draft. The Division plans to recommend one of the alternatives in the final Statement of Position. Therefore, respondents, in commenting on this matter, should indicate, and provide supporting reasons, for their preferences to assist the Division in reaching a decision.

Sincerely,

Thomas W. McRae

Thomas W. McRae
Administrator, Special Projects
Accounting Standards Division

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INTRODUCTION

1. 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.

2. This Statement does not apply to "initial direct costs" of sales-type, operating, and other types of leases the accounting for which is prescribed in Statement of Financial Accounting Standards No. 13, Accounting for Leases. The recommendations in this Statement do not apply to costs directly related to manufacturing, merchandising, or service activities ("commercial activities") as distinguished from real estate activities. This Statement does not apply to 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.

3. In the absence of contrary evidence, the representations of the owners of a real estate project as to 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 and 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

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

   a. As project costs, which are capitalized as part of construction costs.

   b. As prepaid expenses or deferred charges, which are deferred and amortized over future periods.

   c. As period costs, which are charged to expenses immediately as they are incurred.

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

Recommended Practices

5. 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 in paragraph 4 and provide examples of the application of those criteria.

Project Costs

6. Costs to sell real estate projects,[1] 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:

   a. The costs are incurred (i) for tangible assets that are used directly throughout the selling period to aid in the sale of the project or (ii) for services that have been performed to obtain regulatory approval for sales.

   b. The costs are reasonably expected to be recovered from sales of the project or from incidental operations.

Costs that ordinarily meet the criteria for project costs include, for example, the costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semi-permanent signs.

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[1] For the purposes of this Statement, costs to sell real estate projects do not include the costs of amenities, such as golf courses and marinas. The Division is currently studying accounting practices for the costs of amenities, and this Statement is not intended to change those practices.

Prepaid Expenses

7. Costs to sell real estate projects that are expected to benefit future periods should be accounted for as prepaid expenses if they (a) do not meet the criteria for project costs and (b) are incurred for goods or services before the receipt of the services or use of the goods. Costs that ordinarily meet the criteria for prepaid expenses include, for example, costs of future advertising, selling brochures, and advances for future commissions. 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 can be associated with future periods but not with specific future revenue should be charged to expenses in the periods of expected benefit.

Period Costs

8. 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 effects of those costs on sales usually are limited to the period in which they are incurred, and the costs usually provide little discernible future benefits. Costs that should be accounted for as period costs include, for example, costs of advertising that has appeared in the media, sales salaries and sales overhead, and costs of "grand openings."

COSTS INCURRED TO RENT REAL ESTATE PROJECTS

Present Practices

9. 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

10. 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

11. Costs to rent real estate projects[2] under operating leases should be deferred and charged to expenses in future periods if they are incurred for goods or services before the receipt of those goods and services or if they are associated with, and their recovery is reasonably expected from, future rental operations. Such costs should be classified in accordance with the nature of the expenditure. Costs that ordinarily should be deferred and charged to expenses in future periods include, for example, costs of model units and their furnishings, rental facilities, semi-permanent signs, and rental brochures.

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2 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. The Division is currently studying accounting practices for the costs of amenities, and this Statement is not intended to change those practices.

12. Deferred rental costs that are directly related to revenue from a specific operating lease should be amortized over the lease term. The total amount of 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 benefits; the period of amortization should begin when the project is substantially completed and held available for occupancy (see paragraph 18). Unamortized deferred rental costs associated with a terminated lease or group of leases should be charged to expenses when the leases are terminated.

Rental Costs Chargeable to the Current Period

13. Costs to rent real estate projects that do not meet the criteria of paragraph 11 should be accounted for as period costs and charged to expenses as incurred. Costs that should be accounted for as period costs include, for example, costs of advertising that has appeared in the media, rental salaries and rental overhead, and costs of "grand openings."

INITIAL RENTAL OPERATIONS

Present Practices

14. 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.

15. Some companies follow the practice of capitalizing carrying costs and operating expenses net of revenues and of not recording depreciation, or 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.

16. Others follow the practice of capitalizing carrying costs and operating expenses only until a rental project is capable of producing revenues and then discontinue capitalizing carrying costs and begin recording depreciation and all revenues and operating expenses in operations. They believe that the rental or 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

17. 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 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.

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

a. 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, clean-up, and construction of tenant improvements.

b. Units are being or have been offered for rental.

19. 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.[3]

20. Construction activity on a rental project may be suspended before the entire project is substantially completed and held

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3 A portion of a rental project accounted for as a separate project is "a rental project" for the purpose of this Statement.

available for occupancy for reasons such as insufficient rental demand. Conditions such as insufficient rental demand may be indicative of 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.

21. The 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 as they accrue. Amortization of costs to rent the project would be recorded in accordance with the recommendations in the section entitled "Costs Incurred to Rent Real Estate Projects."

22. Because of the variety of existing practices and the complexity of the technical issues, the Division is not now taking a position on accounting for depreciation and carrying costs once a rental project or a portion of a project is substantially completed and held available for occupancy. Rather, to focus attention on the issues and to foster the interchange of ideas, three possible alternative positions are presented for discussion and comment. The Division plans to recommend one of those alternatives in its final Statement of Position. Respondents to this exposure draft should indicate, and provide supporting reasons for, the positions that they advocate.

Alternative A

23. Under Alternative A, the useful life of a rental project that is substantially completed and held available for occupancy

begins to expire in relation to the rental units that are occupied or were expected to be occupied under the owner's original projection for rental achievement.[4] Accordingly, for a rental project that is substantially completed and held available for occupancy, depreciation should begin to be recorded and charged to expenses based on the greater of:

a. The portion of the project that is actually rented or otherwise occupied.

b. The portion of the project that the owner anticipated would be rented based on his original projection for rental achievement.

24. For example, if a rental project with 200 units of equal size and value is substantially completed and held available for occupancy and of the 200 units, 20 units are rented and occupied and 40 units were expected to be occupied at that time under the owner's original projection for rental achievement, paragraphs 21 and 23 would require accounting as follows:

a. Record all rental revenues and income as earned.

b. Begin recording depreciation as an expense on 20% (40/200) of the cost of the project.

Interest and real estate taxes should be accounted for as if the project were completely rented once the project is substantially completed and held available for occupancy.

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4 The owner's original projection for rental achievement might be evidenced, for example, by forecasts submitted in connection with applications for permanent financing.

Alternative B

25. Alternative B is the same as Alternative A with respect to depreciation. However, under Alternative B, if a company capitalizes carrying cost, such as interest and real estate taxes, during construction, it may continue to capitalize carrying costs related to the portion of the project for which depreciation would not begin (see paragraphs 23 and 24) if recovery of those costs is reasonably expected from future rental operations. This conclusion is based on the view that continued capitalization of carrying costs with respect to those portions of a project that are not rented or otherwise occupied and that were not expected to be occupied based on the owner's original projection for rental achievement is appropriate even though the project is substantially completed and held available for occupancy. Those who support this conclusion believe that carrying costs should be charged to expenses on a basis similar to that for depreciation.

Alternative C

26. Accounting for costs other than depreciation is the same under Alternative C as it is under Alternative A. However, in determining depreciation under Alternative C, the useful life of a rental project begins to expire when it is substantially completed and held available for occupancy and is capable of producing revenues, regardless of whether any units were expected

to be occupied under the owner's original projection for rental achievement. Those who support this conclusion view depreciation as a function of the passage of time; thus, under Alternative C, depreciation on the total cost of the project would begin when the project is substantially completed and held available for occupancy.

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APPENDIX

SELECTED ACCOUNTING LITERATURE

27. The three pervasive expense recognition principles are discussed in paragraphs 155 and 156 of APB Statement No. 4:

> 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."

28. Paragraph 161 of APB 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.

29. Associating cause and effect (often referred to as the "matching" process) is commented on in paragraph 157 of APB 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.

30. Paragraphs 159 and 160 of APB 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 a expense of that period (also a systematic and rational allocation). This form of expense recognition always involves assumption 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.

31. The term "initial direct costs" is defined in paragraph 5 (m) of Statement of Financial Accounting Standards No. 13, <u>Accounting for Leases</u>, as follows:

> Those incremental direct costs incurred by the lessor in negotiating and consummating leasing transactions (e.g., commissions and legal fees).

Paragraph 17 (c) of SFAS No. 13 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 SFAS 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 SFAS 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.

32. 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 Accounting Terminology Bulletin No. 1, paragraph 56:

> 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 valuation....

33. 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.

34. Accounting Research Monograph No. 1, Accounting for Depre-Assets, published by the AICPA in 1975, suggests on pages 76-77 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 <u>or</u> when its ability to benefit the company begins to expire, and ending when the asset no longer benefits the company significantly <u>or</u> when its ability to benefit the company expires.

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