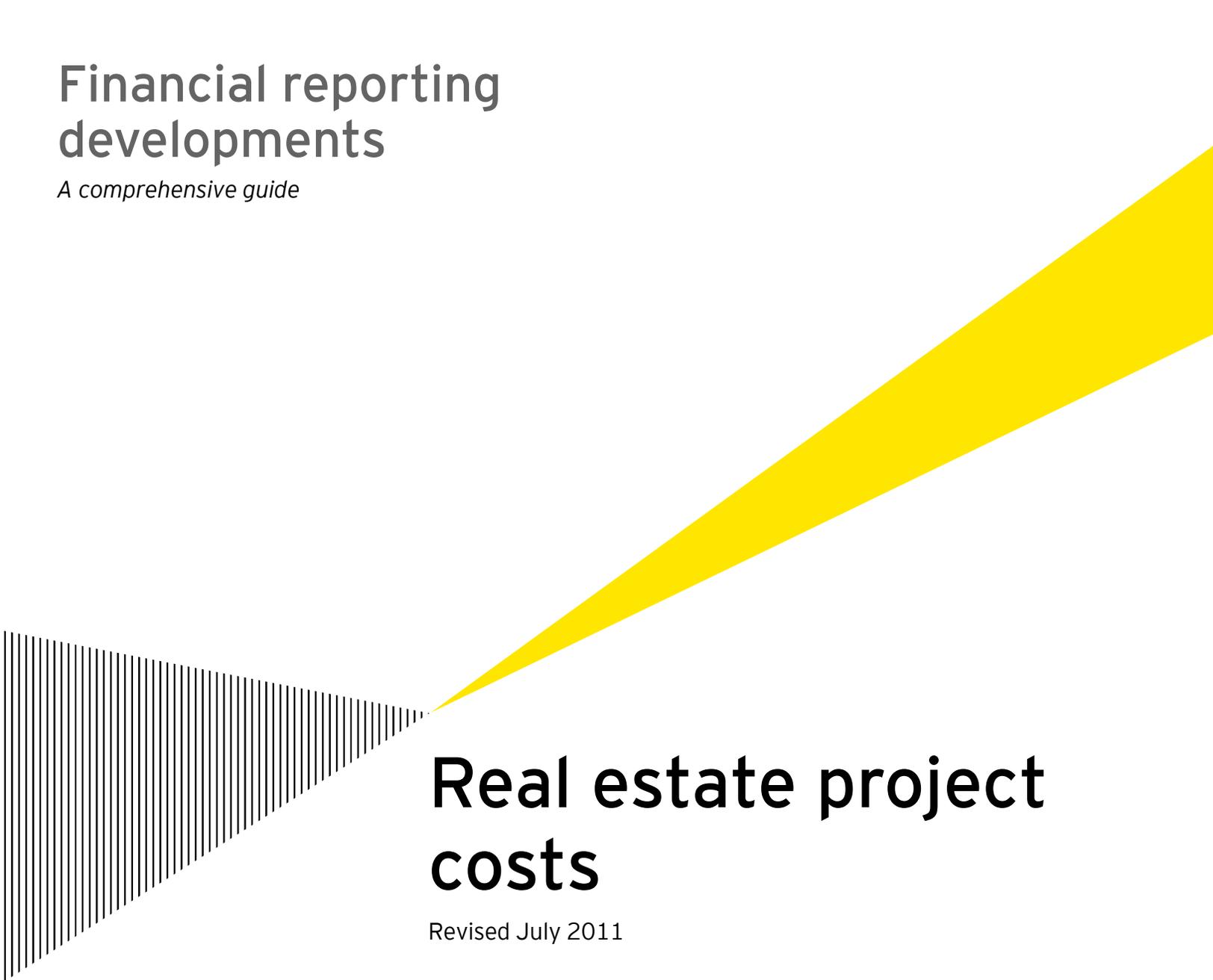


Financial reporting developments

A comprehensive guide



Real estate project costs

Revised July 2011

To our clients and other friends

The guidance for real estate project costs primarily addresses whether costs associated with acquiring, developing, constructing, selling, or renting real estate projects (other than real estate projects developed for an entity's own use) should be capitalized or charged to expense as incurred. While the guidance for real estate project costs (formerly Statement 67) was originally issued more than 25 years ago, determining what costs to capitalize, when to capitalize them and accounting for subsequent measurement considerations (including impairment considerations and accounting for abandoned property) continues to be challenging.

We hope this publication will help you understand and successfully apply the guidance for real estate project costs. Ernst & Young professionals are prepared to assist you in your understanding and are ready to discuss your particular concerns and questions.

Ernst & Young LLP

July 2011

Contents

1	Introduction and scope	1
1.1	General	2
2	Real estate acquisition, development and construction costs	3
2.1	Preacquisition costs	3
2.1.1	Accounting for internal costs relating to real estate property acquisitions	5
2.2	Taxes and insurance	7
2.2.1	Accounting for special assessments and tax increment financing entities	8
2.2.2	Rental costs incurred during a construction period.....	12
2.2.3	Interest	13
2.3	Project costs	13
2.3.1	Accounting for asset retirement obligations, the costs of asbestos removal, and costs to treat environmental contamination	14
2.3.2	Accounting for demolition costs.....	16
2.4	Amenities.....	17
2.5	Incidental operations.....	19
2.6	Allocation of capitalized costs to the components of a real estate project.....	21
2.7	Revisions of estimates.....	23
2.8	Abandonments	23
2.9	Donations to municipalities.....	23
2.10	Changes in use	25
3	Costs incurred to sell and rent real estate	26
3.1	Costs incurred to sell real estate projects	26
3.2	Costs incurred to rent real estate projects.....	28
3.3	Initial rental operations	30
4	Recoverability	33
A	Index of ASC references in this publication	34
B	Abbreviations used in this publication	36

Notice to readers:

This publication includes excerpts from and references to the FASB Accounting Standards Codification (the Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the codification are shown using these reference numbers. References are also made to certain pre-codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

This publication has been carefully prepared but it necessarily contains information in summary form and is therefore intended for general guidance only; it is not intended to be a substitute for detailed research or the exercise of professional judgment. The information presented in this publication should not be construed as legal, tax, accounting, or any other professional advice or service. Ernst & Young LLP can accept no responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. You should consult with Ernst & Young LLP or other professional advisors familiar with your particular factual situation for advice concerning specific audit, tax or other matters before making any decisions.

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1 Introduction and scope

The real estate project costs guidance in ASC 970, *Real Estate – General*, addresses accounting for the costs of real estate projects, including acquisition, development, construction, selling, and initial rental (up to the point of normal operations – as defined) costs. The general principle in the guidance for real estate project costs is that if costs are directly associated with a real estate project (i.e., development, construction, selling, and initial rental), they are capitalized and all other costs are charged to expense as incurred. The guidance for real estate project costs does not address the accounting for the acquisition of a business. See the guidance for business combinations (ASC 805, *Business Combinations*) for further details.

Excerpt from Accounting Standards Codification

Real Estate – General – Overall

Overview and Background

970-10-05-6

The Real Estate Project Costs Subsections establish accounting and reporting standards for acquisition, development, construction, selling, and rental costs associated with real estate projects. They also provide guidance for the accounting for initial rental operations and criteria for determining when the status of a rental project changes from nonoperating to operating.

Scope and Scope Exceptions

970-10-15-7

The guidance in the Real Estate Project Costs Subsections applies to all entities with productive activities relating to real property, excluding property used primarily in the entity's non-real estate operations.

970-10-15-8

The guidance in the Real Estate Project Costs Subsections does not apply to the following transactions and activities:

- a. Real estate developed by an entity for use in its own operations, other than for sale or rental. In this context, real estate developed by a member of a consolidated group for use in the operations of another member of the group (for example, a manufacturing facility developed by a subsidiary for use in its parent's operations) when the property is reported in the group's consolidated financial statements. However, this does not include property reported in the separate financial statements of the entity that developed it.
- b. Initial direct costs of sales-type, operating, and other types of leases, which are defined in Topic 840. The accounting for initial direct costs is prescribed in that Topic.
- c. Costs directly related to manufacturing, merchandising, or service activities as distinguished from real estate activities.

970-10-15-9

Paragraphs 970-340-25-16 through 25-17, 970-340-35-2, 970-340-40-2, and 970-605-25-1 through 25-2 do not apply to real estate rental activity in which the predominant rental period is less than one month.

970-10-15-10

Paragraphs 970-340-25-13 through 25-15 and 970-340-40-1 do not apply to real estate time-sharing transactions. Topic 978 provides guidance on the accounting for those transactions.

The accounting guidance for real estate project costs:

- ▶ Only applies to real estate developed for sale or rent, not real estate developed by an enterprise for its own use in its operations (e.g., a factory or warehouse)
- ▶ Does not apply to real estate developed by one member of a consolidated group for use by another member of the group when the property is included in the group's consolidated financial statements
- ▶ Does not apply to the costs associated with acquiring an operating property (see Section 2.1.1 for further detail)
- ▶ Does not apply to capitalized rental costs for real estate that is rented for less than one month at a time such as a hotel or parking garage that is rented on a daily or weekly basis (see Section 3.2)
- ▶ Does not apply to selling costs (see Section 3.1) related to time-sharing transactions (see ASC 978 for further details)

1.1**General****Excerpt from Accounting Standards Codification**

Real Estate – General – Overall

*Scope and Scope Exceptions***970-10-15-11**

This Subsection specifies the accounting for the following as they relate to real estate projects:

- a. Preacquisition costs
- b. Taxes and insurance
- c. Project costs
- d. Amenities
- e. Incidental operations
- f. Allocation of capitalized costs to components of a real estate project
- g. Revisions of estimates
- h. Abandonments and changes in use
- i. Selling costs
- j. Rental costs
- k. Reductions in the carrying amounts of real estate assets prescribed by the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10.

Refer to Sections 2.1 – 4.1 for detailed guidance on the accounting for real estate project costs.

2 Real estate acquisition, development and construction costs

In general, costs (both direct and indirect) specifically associated with a real estate project that is under development should be capitalized. All other costs should be charged to expense as incurred.

2.1 Preacquisition costs

Excerpt from Accounting Standards Codification

Preacquisition Costs

Costs related to a property that are incurred for the express purpose of, but prior to, obtaining that property. Examples of preacquisition costs may be costs of surveying, zoning or traffic studies, or payments to obtain an option on the property.

Real Estate – General – Other Assets and Deferred Costs

Recognition

970-340-25-3

Payments to obtain an option to acquire real property shall be capitalized as incurred. All other costs related to a property that are incurred before the entity acquires the property, or before the entity obtains an option to acquire it, shall be capitalized if all of the following conditions are met and otherwise shall be charged to expense as incurred:

- a. The costs are directly identifiable with the specific property.
- b. The costs would be capitalized if the property were already acquired.
- c. Acquisition of the property or of an option to acquire the property is probable (that is, likely to occur). This condition requires that the prospective purchaser is actively seeking to acquire the property and has the ability to finance or obtain financing for the acquisition and that there is no indication that the property is not available for sale.

970-340-25-4

Capitalized preacquisition costs either:

- a. Shall be included as project costs upon the acquisition of the property
- b. To the extent not recoverable by the sale of the options, plans, and so forth, shall be charged to expense when it is probable that the property will not be acquired.

Preacquisition costs are defined as “costs related to a property that are incurred for the express purpose of, but prior to, obtaining the property.” Examples of preacquisition costs include costs incurred to obtain an option to acquire real estate and other costs incurred prior to obtaining the property, such as: zoning costs, environmental or feasibility studies, legal fees, finder’s fees, appraisals, and project planning costs. Costs incurred to obtain an option to acquire real estate, either from the property owner or the holder of an option, should be capitalized. All costs directly identifiable with a specific property that are incurred before an entity acquires the property, or before the entity obtains an option to acquire the property, should be

capitalized if acquisition of the property, or an option to acquire the property, is probable and the costs would be capitalized if the property were already acquired. The specific property identified should be available for sale and the prospective purchaser must be actively seeking to acquire the property and have the ability to finance or obtain financing for the acquisition. All other costs, including general and administrative costs incurred during the preacquisition phase, should be charged to expense as incurred.

Illustration 2-1: Capitalized costs not directly identifiable with a specific property

Facts:

Company A is committed to constructing an office building to be leased to third parties in Boston. Management is currently evaluating three potential sites and believes it is probable that one of these sites will be acquired. However, no one site is more likely to be acquired than any of the others. Company A has incurred \$50,000 in costs to establish local real estate contacts and research zoning and building codes.

Analysis:

Although Company A believes it is probable that one of the three potential sites will be acquired, because it is not probable that any one site will be acquired, the costs incurred are not directly identifiable with a specific property that is probable of being acquired. Therefore, the \$50,000 in costs incurred to establish local real estate contracts and research zoning and building codes should be charged to expense as incurred.

In determining whether the acquisition of a property or an option to acquire the property is probable, companies should look to the definition of “probable” used in ASC 450-20, *Contingencies – Loss Contingencies*. As long as it is probable that an entity will acquire a specific property or an option to acquire that property, preacquisition costs should be capitalized and the asset should be evaluated for recoverability using the guidance for the impairment of long-lived assets (ASC 360-10), whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

If an entity determines that acquisition of a property is no longer probable, no new costs should be capitalized. Additionally, the fact that it is no longer probable that the property will be acquired may be an indicator of impairment requiring costs previously capitalized to be evaluated for recoverability in accordance with the provisions of ASC 360-10. If it becomes probable that a property will not be acquired, all capitalized costs should be written off to the extent the costs are not recoverable through sale (i.e., sale of an option, plans, etc.).

The following table summarizes these concepts:

Likelihood of acquisition	Capitalize new qualified preacquisition costs?	Treatment of previously capitalized costs
Acquisition of property or option is probable	Yes	Evaluate for recoverability in accordance with the guidance for the impairment of long-lived assets (ASC 360-10) if impairment indicator exists
Acquisition of property or option is reasonably possible	No	Evaluate for recoverability in accordance with the guidance for the impairment of long-lived assets (ASC 360-10) if impairment indicator exists
Probable that property will not be acquired	No	Write-off all costs unless recoverable through direct sale

Illustration 2-2: Evaluation of capitalized costs**Facts:**

Company A is committed to constructing an office building in Chicago at a specified site. Company A has an option to acquire the site and has capitalized \$50,000 in preacquisition costs to date. Company A has not made any noticeable progress toward acquiring the property or development approval in several months and no longer believes that it is probable that the property will be acquired but still believes it is reasonably possible that the property will be acquired.

Analysis:

No new preacquisition costs should be capitalized because Company A has concluded that it is no longer probable that the property will be acquired. Additionally, the \$50,000 in costs previously capitalized should be evaluated for recoverability in accordance with the guidance for the impairment of long-lived assets (ASC 360-10). If Company A subsequently determines it is probable that the property will not be acquired, all capitalized costs not recoverable through a direct sale should be charged to expense.

2.1.1 Accounting for internal costs relating to real estate property acquisitions

Excerpt from Accounting Standards Codification**Real Estate – General – Other Assets and Deferred Costs****Recognition****970-340-25-5**

The view that all internal costs of identifying and acquiring commercial properties should be deferred and, in some manner, capitalized as part of the cost of successful property acquisitions is not appropriate.

970-340-25-6

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) shall be capitalized as part of the cost of that acquisition.

970-340-25-7

Paragraph 970-340-25-17 is also applicable in situations in which the acquired property is partially operating and partially nonoperating.

Subsequent Measurement**970-340-35-3**

If an entity subsequently determines that a property will be classified as operating at the date of acquisition, the internal costs of preacquisition activities shall be charged to expense and any additional costs shall be expensed as incurred.

970-340-35-4

If an entity subsequently determines that a property will be classified as nonoperating at the date of acquisition, previously expensed internal costs of preacquisition activities shall not be capitalized as part of the cost of that acquisition.

Real Estate – General – Other Expenses

Recognition

970-720-25-1

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 shall be expensed as incurred.

970-720-25-2

A property would be considered operating if, at the date of acquisition, major construction activity (as distinguished from activities such as routine maintenance and cleanup) is substantially completed on the property and either of the following conditions exists:

- a. It is held available for occupancy upon completion of tenant improvements by the acquirer.
- b. It is already income-producing.

Many companies have internal real estate acquisition departments. The employees in these departments spend their time searching for and managing the acquisition of real estate properties. An entity should capitalize internal costs of preacquisition activities if the costs are directly identifiable with a **specific** nonoperating property, and they were incurred subsequent to the time the acquisition of that **specific** nonoperating property was considered probable. Such costs should only be capitalized if the property will be classified as nonoperating at the date of acquisition. If the property will be classified as operating at the date of acquisition, internal preacquisition costs should be charged to expense as incurred.

A property should be considered operating if major construction activity (versus activities such as routine maintenance and cleanup) is substantially completed on the property and (a) it is held available for occupancy on completion of tenant improvements by the acquirer or (b) it is already income producing. For example, an entity planning to purchase an apartment building that is currently occupied by tenants should not capitalize the internal costs associated with the acquisition of that property, even if the costs are directly identifiable with the property and acquisition of the property is probable. If instead the entity was planning to build an apartment building on a specific piece of land and the acquisition of that land is considered probable, internal costs directly associated with acquiring the land should be capitalized.

If an entity initially determines a property will be classified as nonoperating but subsequently determines that the property will be classified as operating at the date of acquisition, previously capitalized costs should be charged to expense and any additional costs should be charged to expense as incurred. However, if an entity initially determines a property will be classified as operating but subsequently determines that the property will be classified as nonoperating at the date of acquisition, the entity should not capitalize amounts previously charged to expense. The guidance for real estate project costs does not address the accounting for the acquisition of a business (see ASC 805 for further details).

Consistent with ASC 970-340-25-17 (see Section 3.3), 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, each portion of the project should be accounted for as a separate project. Costs should be allocated between the portions under construction (nonoperating) and the portions substantially completed and held available for occupancy (operating), and the costs allocated to the nonoperating portions should be capitalized if they are directly identifiable with the property and were incurred subsequent to the time the acquisition of the property was considered probable, and those related to the operating portion should be charged to expense.

Illustration 2-3: Potential sites are all nonoperating properties**Facts:**

Company A is committed to constructing an office building in Boston that will be leased to third parties (i.e., the building will not be for internal use). Company A has an internal real estate acquisition department that incurs \$50,000 in costs while evaluating three potential sites for the building. Once one of the three sites is selected and is deemed probable of being acquired, the internal real estate acquisition department incurs an additional \$10,000 in costs directly associated with acquiring the selected property.

Analysis:

Because the property being acquired is a nonoperating property (Company A is planning to construct an office building on the land acquired), Company A should capitalize the \$10,000 in costs that were incurred after it was probable that the property would be acquired. The \$50,000 in costs incurred before the acquisition of a specific property was probable (i.e., while evaluating three potential sites) should be charged to expense as incurred.

Illustration 2-4: Potential sites are at various stages of completion**Facts:**

Company A is committed to owning an office building in Boston that will be leased to third parties (i.e., the building will not be for internal use). Company A has an internal real estate acquisition department that incurs \$50,000 in costs while evaluating three potential properties. Property A is under construction; Property B has been recently completed and is available for occupancy; Property C is 75-percent occupied. Once one of the three sites is selected and deemed probable of being acquired, the internal real estate acquisition department incurs an additional \$10,000 in costs directly associated with acquiring the selected property.

Analysis:

The \$50,000 in costs incurred before the acquisition of a specific property was probable should be charged to expense as incurred. Additionally, Company A should only capitalize the additional \$10,000 in costs directly associated with acquiring the selected property if the property that is under construction (Property A) is selected. The other two properties (Properties B and C) would be considered operating properties and, as such, no preacquisition costs should be capitalized.

2.2**Taxes and insurance****Excerpt from Accounting Standards Codification****Real Estate – General – Other Assets and Deferred Costs****Recognition****970-340-25-8**

Costs incurred on real estate for property taxes and insurance shall be capitalized as property cost only during periods in which activities necessary to get the property ready for its intended use are in progress. The phrase *activities necessary to get the property ready for its intended use are in progress* is used here with the same meaning as it has for interest capitalization in paragraphs 835-20-25-3 through 25-4 and 835-20-25-8. Costs incurred for such items after the property is substantially complete and ready for its intended use shall be charged to expense as incurred. The phrase *substantially complete and ready for its intended use* is used here with the same meaning as it has for interest capitalization in paragraph 835-20-25-5.

Costs incurred for property taxes and insurance on real estate should be accounted for in a manner that is similar to interest costs, which are addressed in ASC 835-20, *Interest – Capitalization of Interest* (see Section 2.2.3), in that the period of capitalization is the same. Property taxes and insurance costs should only be capitalized during periods in which activities necessary to get a property ready for its intended use are in progress. ASC 835-20-20 indicates that the term “activities” is to be “construed broadly” and encompasses more than just physical construction. For example, preconstruction activities, such as developing plans or obtaining permits, and activities undertaken to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation, would all qualify as activities necessary to get the property ready for its intended use. If an entity suspends substantially all activities related to the project, tax and insurance cost capitalization should cease until activities are resumed. However, an entity is not required to suspend cost capitalization for brief interruptions, interruptions that are externally imposed, or delays that are inherent in the development process. Taxes and insurance should not be capitalized if the owner is simply holding the property for future development, but has not commenced development activities.

Once the property is substantially complete and ready for its intended use, tax and insurance costs should be charged to expense as incurred. The point at which an asset is substantially complete and ready for its intended use depends on the nature of the asset (ASC 835-20-25-5). Some assets are completed in stages and the completed stages can be used while work is continuing on the other stages (e.g., individual condominium units or individual floors in an office building). Other assets must be completed in their entirety before any part of the asset can be used (e.g., a warehouse that will be leased to one tenant). If some portions of an asset are substantially complete and ready for use and other portions have not yet reached that stage, the substantially completed portions should be accounted for as a separate project and capitalization of tax and insurance costs on that portion of the project should cease. A project held for occupancy (rental property) is substantially complete and held available for occupancy upon the completion of tenant improvements by the developer but no later than one year from cessation of major construction activity (as distinguished from activities such as routine maintenance and cleanup). See Section 3.3 for additional details.

2.2.1 Accounting for special assessments and tax increment financing entities

Excerpt from Accounting Standards Codification

Real Estate – General – Debt

Overview and Background

970-470-05-2

Municipalities often levy special assessments to finance the construction of certain infrastructure assets or improvements or may levy special assessments for other specified purposes. Alternatively, an entity that intends to develop real estate it owns or leases may form a tax increment financing entity to finance and operate the project infrastructure. Tax increment financing entities are authorized under various state statutes to issue bonds to finance the construction of road, water, and other utility infrastructure for a specific project. Usually, all of the debt is issued by the tax increment financing entity and will be repaid by future user fees or taxes assessed to cover operating costs, such as repairs and maintenance, as well as debt service.

970-470-05-3

The Variable Interest Entities Subsections of Subtopic 810-10 address consolidation by business entities of variable interest entities (VIEs), which may include many special-purpose entities of the type used as tax increment financing entities.

Recognition**970-470-25-1**

If the special assessment or the assessment to be levied by the tax increment financing entity on each individual property owner is a fixed or determinable amount for a fixed or determinable period, there is a presumption that an obligation shall be recognized by the property owner. Further, with respect to tax increment financing entities, factors such as the following indicate that an entity may be contingently liable for tax increment financing entity debt, and recognition of an obligation shall be evaluated under Topic 450:

- a. The entity must satisfy any shortfall in annual debt service obligations.
- b. There is a pledge of entity assets.
- c. The entity provides a letter of credit in support of some or all of the tax increment financing entity debt or provides other credit enhancements.

970-470-25-2

If the entity is constructing facilities for its own use or operation, the presence of any of the factors in the preceding paragraph creates a presumption that the tax increment financing entity debt must be recognized as an obligation of the entity.

970-470-25-3

An entity's agreement to either make up shortfalls in the annual debt service requirements or guarantee the tax increment financing entity's debt, as described in Example 1, Cases C through D (see paragraphs 970-470-55-9 through 55-14), may be guarantees under the characteristics found in paragraph 460-10-15-4 and subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460.

970-470-25-4

See Section 970-470-55 for examples of accounting for special assessments and tax increment financing entities.

970-470-25-5

See Section 974-605-25 for adjustment of assets (or liabilities) transferred between a real estate investment trust and its adviser.

Infrastructure assets or improvements, such as roads, water lines, and other utilities, are often financed through special tax assessments. A municipality may levy a special assessment to finance the infrastructure or a real estate developer may form a Tax Increment Financing Entity (TIFE) that is authorized to issue bonds to finance and operate the project infrastructure. When a TIFE issues bonds, the debt is generally repaid by future user fees or taxes assessed on the property to cover operating costs, such as repairs and maintenance, and debt service (i.e., the property owner is responsible for repaying the debt and the repayment obligation remains attached to the property if it is sold).

ASC 970-470, *Real Estate – General – Debt*, addresses whether companies should recognize a liability for special assessments from municipalities or for TIFE debt. Under this guidance, there is a presumption that an obligation should be recognized if the assessment to be levied by the municipality or TIFE on each individual property owner is fixed or determinable (i.e., a fixed or determinable amount for a fixed or determinable period).

Even if the assessment to be levied by a TIFE on each individual property owner is not fixed or determinable, factors such as the following are indicators that an entity may be contingently liable for TIFE debt, and recognition of an obligation should be evaluated using the guidance in ASC 450, *Contingencies*:

- ▶ The entity must satisfy any shortfall in annual debt service obligations
- ▶ There is a pledge of company assets
- ▶ The entity provides a letter of credit in support of some or all of the TIFE debt or provides other credit enhancements

If an entity is constructing facilities for its own use or operation (this would include rental or sale), the presence of any of the above factors creates a presumption that the TIFE debt should be recognized as an obligation of the entity.

The following examples are included in the accounting guidance for special assessments and tax increment financing entities (ASC 970-470) and demonstrate the application of this guidance to specific situations:

Excerpt from Accounting Standards Codification

Real Estate – General – Debt

Implementation Guidance and Illustrations

970-470-55-2

Cases A, B, C, and D share the following assumptions:

- a. The entity owns 100 percent of the land under development.
- b. \$10 million of bonds are issued for construction of the development infrastructure.
- c. The interest rate on the bonds is 6 percent and the term is 20 years.
- d. The annual debt service requirement is \$500,000 principal repayment plus interest accrued during the year.
- e. The project is expected to take 10 years to complete, and no significant sales of property are expected until the third year. All of the property under development is intended for sale.
- f. The property under development is subject to lien if there is a default on the assessment.

Case A: Municipality Bond Issue; Entity Obligation Recognized for Special Assessment

970-470-55-3

A municipality issues bonds to finance construction of the infrastructure assets. The municipality levies a special assessment on the property that is equal to the face amount of the bonds. The special assessment bears interest at the same rate as the bonds. In this Case, if there are 100 equal-sized parcels in the development, each parcel will be assessed \$5,000 per year plus accrued interest for 20 years. The assessment remains with the property. Accordingly, upon sale or partial sale of the development, the entity must pay the remaining assessment on the property sold or the purchaser must assume the obligation.

970-470-55-4

The entity must recognize an obligation for the special assessment because the amount is fixed for a fixed period of time. Subsequent property owners that assume the obligation must recognize the obligation related to the parcels purchased.

Case B: Tax Increment Financing Entity; Entity Obligation Recognized for Debt**970-470-55-5**

A tax increment financing entity is formed to issue bonds. On completion of construction of the infrastructure assets, title to such assets (including any land upon which the infrastructure is constructed) passes from the tax increment financing entity to the municipality. The entity does not guarantee the tax increment financing entity debt.

970-470-55-6

Property owners will be subject to a tax on an equal basis determined by the number of lots in the district. The tax will be levied annually, based on the tax increment financing entity's debt service requirement for that year. Accordingly, if there are 100 parcels in the development, \$5,000 plus interest accrued for the year is expected to be levied on each parcel annually for the 20 years the debt is outstanding. Additional assessments may be levied by the tax increment financing entity for maintenance or other services. These assessments are in addition to normal property tax assessments.

970-470-55-7

Upon sale of a portion of the property, either the entity must repay a pro rata portion of the tax increment financing entity debt or the purchaser must assume the obligation.

970-470-55-8

The entity must recognize an obligation for the tax increment financing entity debt because the assessment in this example is a determinable amount for a determinable period of time.

Case C: Tax Increment Financing Entity; No Entity Obligation Recognized**970-470-55-9**

A tax increment financing entity is formed to issue bonds. On completion of construction of the infrastructure assets, title to such assets (including any land upon which the infrastructure is constructed) passes from the tax increment financing entity to the municipality. The entity does not guarantee the tax increment financing entity debt.

970-470-55-10

The rates for annual assessments are determined prior to issuance of the debt and are limited to a maximum annual tax rate based on anticipated debt service requirements. The rate levied is dependent on the land use category of each parcel of property in the district. Developed property is taxed at the maximum rate, unless a lesser amount is needed to meet current year debt service and maintenance obligations. If the amount levied for developed property is not sufficient, undeveloped property is subject to tax up to the maximum rate. If the maximum rate applied to both developed and undeveloped property is insufficient, additional taxes may be assessed only if approved by eligible voters.

970-470-55-11

Because the assessment on each individual property owner is dependent upon the rate of development and, therefore, is not fixed or determinable, an obligation is not required to be recognized. However, if the entity must satisfy any shortfall in annual debt service requirements, recognition of an obligation must be evaluated pursuant to Subtopic 450-20.

Case D: Tax Increment Financing Entity; No Entity Obligation Recognized**970-470-55-12**

A tax increment financing entity is formed to issue bonds. On completion of construction of the infrastructure assets, title to such assets (including any land upon which the infrastructure is constructed) passes from the tax increment financing entity to the municipality. The entity does not guarantee the tax increment financing entity debt.

970-470-55-13

The debt service requirements of the tax increment financing entity will be met by normal property tax assessments. The increased value of the developed property is expected to generate sufficient taxes to meet the debt service and other obligations. If such assessments are not sufficient, the municipality must satisfy the shortfall.

970-470-55-14

The assessment on each individual property is not determinable because it is based on the current tax rate and the assessed value of the property. Accordingly, the entity is not required to recognize an obligation. The assessments will be treated as property taxes. If, however, the company had guaranteed the tax increment financing entity debt or must satisfy any shortfall in annual debt service requirements, the recognition of an obligation would be evaluated pursuant to Subtopic 450-20.

The potential effects of guarantees (such as an entity's agreement to make up shortfalls in the annual debt service requirements or guarantee the tax increment financing entity's debt) and consolidation considerations for special-purpose entities of the type used as tax increment financing entities should also be considered. See the guidance for guarantees and special-purpose entities in ASC 460, *Guarantees*, and the Variable Interest Subsections of ASC 810, *Consolidations*, for more details.

ASC 970-470 only addresses when a liability should be recorded for a special assessment or TIFE debt and not whether an asset or expense should be recognized when the liability is recorded. Generally, once construction of the infrastructure assets is complete, title to the assets (including any land on which the infrastructure is constructed) passes from the TIFE to the municipality. Although the developer does not retain title to the assets, we believe the costs associated with a special assessment or TIFE debt relate to the overall development of the real estate project and should be capitalized as project costs. This treatment is consistent with the treatment of real estate donated to municipalities for use that will benefit the project which is allocated as a common cost of the project (ASC 970-360-35-1, see Section 2.9 for further discussion).

When an entity has recorded a liability in accordance with ASC 970-470 and the property to which the obligation is attached is sold, the extinguished liability and capitalized costs should be included in the profit or loss calculation. If a transaction does not qualify for sales treatment, the obligation and capitalized costs should remain on the seller's balance sheet (refer to our Financial Reporting Developments booklet, *Real Estate Sales* for additional guidance on accounting for the sale of real estate).

2.2.2 Rental costs incurred during a construction period

In some lease arrangements, a lessee may have the right to use leased property prior to commencing operations or making rental payments in order to construct a lessee asset (e.g., leasehold improvements). The accounting guidance for leases (ASC 840-20-25-10 through 25-11) prohibits an end user lessee from capitalizing rent under an operating lease into the cost of a constructed asset (refer to our Financial Reporting Developments booklet, *Lease Accounting – A Summary*, for additional information). However, the accounting guidance for leases does not address whether a lessee that accounts for the sale or rental of real estate projects under the applicable guidance in ASC 970 should

capitalize rental costs associated with ground and building operating leases. Therefore, we believe that whether a lessee accounting for the sale or rental of real estate projects in accordance with ASC 970 capitalizes or expenses rental costs associated with ground and building operating leases is a policy election that should be disclosed and consistently applied. If capitalized, the period of capitalization and related accounting should follow ASC 970-340-25-8 (see Section 2.2 for further details).

2.2.3 Interest

ASC 835-20, *Interest – Capitalization of Interest*, establishes standards of financial accounting and reporting for capitalizing interest cost as a part of the historical cost of acquiring certain assets. Assets that qualify for capitalization of interest include: assets that are constructed or otherwise produced for an enterprise's own use; assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., real estate projects subject to the applicable guidance in ASC 970); and investments (e.g., equity, loans, and advances) accounted for by the equity method if 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 (refer to ASC 835-20).

As discussed in Section 2.2, interest costs and costs incurred for property taxes and insurance on real estate should be accounted for in a similar manner. Interest should only be capitalized during periods in which activities necessary to get the property ready for its intended use are in progress (or in the case of an equity method investment, until the planned principal operations of the investee begin). If an entity suspends substantially all activities related to the project, cost capitalization should cease until activities are resumed. However, an entity is not required to suspend cost capitalization for brief interruptions, interruptions that are externally imposed, or delays that are inherent in the development process.

2.3 Project costs

Excerpt from Accounting Standards Codification

Project Costs

Costs clearly associated with the acquisition, development, and construction of a real estate project.

Indirect Project Costs

Costs incurred after the acquisition of the property, such as construction administration (for example, the costs associated with a field office at a project site and the administrative personnel that staff the office), legal fees, and various office costs, that clearly relate to projects under development or construction. Examples of office costs that may be considered indirect project costs are cost accounting, design, and other departments providing services that are clearly related to real estate projects.

Real Estate – General – Property, Plant, and Equipment

Recognition

970-360-25-2

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

970-360-25-3

Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate.

Real Estate – General – Other Expenses**Recognition****970-720-25-3**

Indirect costs that do not clearly relate to projects under development or construction, including general and administrative expenses, shall be charged to expense as incurred.

Costs that are clearly associated with the acquisition, development, and construction of a real estate project should be capitalized as project costs. Direct project costs include costs such as the cost of land acquisition, building materials, or project plans. Indirect project costs should be capitalized if they clearly relate to the specific real estate project or several different projects (all of which qualify for capitalization) under development. Indirect project costs that are clearly related to the real estate project or projects may include construction administration costs (e.g., costs associated with a field office at a project site), legal fees, and various other costs (e.g., cost accounting and design). If indirect project costs are associated with several projects under development, the costs should be allocated to the projects on a consistent and rational basis. Indirect costs that do not clearly relate to the acquisition, development, or construction of a real estate project, including most general and administrative costs, should be charged to expense as incurred.

It may often be difficult to distinguish between indirect project costs that should be capitalized and general and administrative costs that should be charged to expense. This is further complicated by the fact that one entity may include appropriately capitalizable costs in a separate development department while another entity may not. In general, we believe there is a presumption that shared costs should not be capitalized unless they are incremental to development (i.e., the costs would not have been incurred in the absence of the project or projects under development).

2.3.1 **Accounting for asset retirement obligations, the costs of asbestos removal, and costs to treat environmental contamination**

An entity may incur costs to remove, contain, neutralize, or prevent existing or future environmental contamination of a property. These costs may be incurred voluntarily or may be required by law. Additionally, various federal, state, and local laws require the removal or containment of “dangerous asbestos” in buildings and regulate the manner in which the asbestos should be removed or contained.

ASC 410-20, *Asset Retirement and Environmental Obligations – Asset Retirement Obligations*, applies to legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, development, and (or) the normal operation of a long-lived asset. In ASC 410-20, a legal obligation is an obligation a party is required to settle as a result of an existing or enacted law, statute, ordinance, written or oral contract, or a promise and an expectation of performance (i.e., under the doctrine of promissory estoppel.)

For asset retirement obligations accounted for in accordance with ASC 410-20, the fair value of the liability for asset retirement obligations is recognized in the period in which it is incurred, or in the period in which a property with an existing retirement obligation is acquired, provided that a reasonable estimate of fair value can be made. Upon initial recognition, the costs are capitalized as part of the carrying amount of the related long-lived asset. For example, an asset retirement obligation may result from construction (e.g., construction of an asset creates the obligation to dismantle and remove the asset at some point in the future), in which case the obligation would be recognized as the asset is constructed. In another example, the asset retirement obligation could result from a new law (e.g., a new law that requires the replacement of all the pipes in an office building at some point in the future), in which case the obligation would be recognized at the time that the new law is enacted. Refer to our Financial Reporting Developments booklet, *Asset Retirement Obligations*, for detailed guidance on the accounting for asset retirement obligations.

An environmental remediation liability that results from the normal operation of a long-lived asset and that is associated with the retirement of that asset is within the scope of ASC 410-20. However, an environmental remediation liability that results from other than the normal operation of a long-lived asset should fall within the scope of ASC 410-30, *Asset Retirement and Environmental Obligations – Environmental Obligations*. For example, environmental remediation liabilities that relate to pollution arising from some past act (e.g., a Superfund violation) that will be corrected without regard to retirement activities are subject to the provisions of ASC 410-30. Similarly, for the costs of asbestos removal that result from the other-than-normal operation of an asset are not within the scope of ASC 410-20 but may be subject to the provisions of ASC 410-30 (e.g., if the company has an obligation to remove the asbestos). Refer to our Financial Reporting Developments booklet, *Environmental Obligations*, for more details.

The guidance for environmental obligations may also apply to costs incurred to remove asbestos or treat environmental contamination that do not relate to a legal obligation, such as costs to voluntarily improve the safety of an asset (e.g., voluntarily removing asbestos in a foreign jurisdiction where no laws exist to obligate its removal or voluntarily removing the lead pipes in a building and replacing them with copper pipes to improve the safety of the building's water system) or costs to prepare the property for sale. However, as demonstrated by two of the illustrative examples in ASC 410-20-55, asbestos removal will generally fall within the guidance for asset retirement obligations. In the unusual event that asbestos removal costs are not accounted for using the guidance for asset retirement obligations (ASC 410-20), the guidance for environmental obligations (ASC 410-30) would apply and the costs of asbestos removal may be capitalized and/or deferred in the following situations:

- ▶ If costs are incurred within a reasonable time period after a property with a known asbestos problem is acquired, the costs should be capitalized as part of the cost of the acquired property, subject to an impairment test (i.e., the guidance for the impairment of long-lived assets in ASC 360-10) for that property.
- ▶ If costs are incurred to treat asbestos in an existing property, the costs may be capitalized as a betterment, subject to an impairment test for that property.
- ▶ If costs are incurred in anticipation of a sale of property, they should be deferred and recognized in the period of sale to the extent those costs are recoverable based on the estimated sales price.

In general, other costs incurred to treat environmental contamination (not within the scope of ASC 410-20) should be charged to expense as incurred in accordance with the guidance for environmental obligations (ASC 410-30). Those costs may be capitalized if recoverable but only if any one of the following criteria is met:

- ▶ The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the entity. The condition of the property after the costs are incurred must have improved as compared with the condition of the property when originally constructed or acquired, if later. For example, costs incurred to remove lead pipes in an office building and replace them with copper pipes to improve the safety of the building's water system compared with its condition when the water system was originally acquired may be capitalized if the costs are recoverable.
- ▶ The costs mitigate or prevent environmental contamination that has yet to occur and that otherwise may result from future operations or activities. Additionally, the costs improve the property compared with its condition when constructed or acquired, if later. For example, the costs of installing water filters in a well to prevent future contamination may be capitalized if the costs are recoverable.
- ▶ The costs are incurred in preparing property for sale that is currently held for sale.

2.3.2 Accounting for demolition costs

An entity may purchase property with the intention of demolishing the existing structure and replacing it with a new structure or with the intention of reconstructing the interior of the building (e.g., gutting the interior of a warehouse in preparation for reconstructing the interior as office space). Alternatively, an entity may purchase property with the intention of operating the property, but later decide to demolish and replace the property with a new structure. When there is a change in the use of real estate (e.g., when a golf course is converted to an office building complex), the guidance for real estate project costs (ASC 970-360-35-2) indicates that the previously capitalized development and construction costs need not be written off if certain conditions are met (see Section 2.10). However, the guidance for real estate project costs does not address demolition costs or the accounting for previously capitalized development and construction costs when there is no change in use (i.e., a 20-year old hotel is demolished and replaced with a new hotel).

Demolition costs incurred in conjunction with the acquisition of real estate may be capitalized as part of the cost of the acquisition if the demolition (a) is contemplated as part of the acquisition and (b) occurs within a reasonable period of time after the acquisition, or is delayed, but the delay is beyond the entity's control (e.g., demolition cannot commence until the end of an existing tenant's lease term, which will expire shortly after acquisition or demolition is subject to governmental permitting processes). If an entity purchases property with the intention of demolishing the existing structure and replacing it with a new structure, the entire purchase price and the costs of demolition should be allocated to the cost of the land.

Illustration 2-5: Demolition costs

Facts:

Company A acquires land with a preexisting structure from Company B. Due to the nature and age of the structure on the site, the land is worth more without the structure than with the structure. Soon after the acquisition, Company A, as contemplated at the time of purchase, incurs costs to demolish the structure.

Analysis:

It is appropriate for Company A to capitalize the costs to demolish the structure as incremental costs of the acquired land.

If an entity purchases a property with the intention of demolishing and rebuilding the interior of the building only, the purchase price and costs of demolition should be allocated between the land and building with the demolition component assigned solely to the building.

If a demolition was not contemplated as part of an acquisition of real estate or the demolition does not occur within a reasonable period of time after the acquisition, the costs of the demolition should be charged to expense as incurred, unless the demolition is accounted for as an asset retirement obligation (ARO) in accordance with ASC 410-20.

2.4

Amenities**Excerpt from Accounting Standards Codification****Amenities**

Features that enhance the attractiveness or perceived value of a time-sharing interval. Examples of amenities include golf courses, utility plants, clubhouses, swimming pools, tennis courts, indoor recreational facilities, and parking facilities. See also Planned Amenities and Promised Amenities.

Common Costs

Costs that relate to two or more units or phases within a real estate or time-sharing project.

Real Estate – General – Other Assets and Deferred Costs**Recognition****970-340-25-9**

Accounting for costs of amenities shall be based on management's plans for the amenities in accordance with the following:

- a. If an amenity is to be sold or transferred in connection with the sale of individual units, costs in excess of anticipated proceeds shall be allocated as **common costs** because the amenity is clearly associated with the development and sale of the project. The common costs include expected future operating costs to be borne by the developer until they are assumed by buyers of units in a project.
- b. If an amenity is to be sold separately or retained by the developer, capitalizable costs of the amenity in excess of its estimated fair value as of the expected date of its substantial physical completion shall be allocated as common costs. For the purpose of determining the amount to be capitalized as common costs, the amount of cost previously allocated to the amenity shall not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value as of the date of substantial physical completion, less any accumulated depreciation, results in a gain or loss that shall be included in net income in the period in which the sale occurs.

970-340-25-10

Costs of amenities shall be allocated among land parcels benefited and for which development is probable. A land parcel may be considered to be an individual lot or unit, an amenity, or a phase. The fair value of a parcel is affected by its physical characteristics, its highest and best use, and the time and cost required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors.

970-340-25-11

Before an amenity is substantially completed and available for use, operating income (or loss) of the amenity shall be included as a reduction of (or an addition to) common costs. When an amenity to be sold separately or retained by the developer is substantially completed and available for use, current operating income and expenses of the amenity shall be included in current operating results.

Real estate projects commonly include amenities, such as golf courses, utility plants, clubhouses, swimming pools, tennis courts, indoor recreational facilities, and parking facilities. Companies should account for the costs of amenities based on management's plans for the amenities as follows:

- ▶ If management plans to sell or transfer an amenity in connection with the sale of individual units (e.g., a clubhouse that will be transferred to the homeowners association in a housing development), the amenity is clearly associated with the development, and sale of the project and costs in excess of anticipated proceeds should be accounted for as common costs (costs that relate to two or more units within a real estate project), and allocated to the individual units based on the relative fair value of each unit before construction (see Section 2.6 for additional guidance on allocating common costs). The transfer of an amenity is equivalent to a sale for no consideration (i.e., 100 percent of costs are common costs). Allocated costs should include expected future operating costs to be borne by the developer until the asset is sold or transferred. Any operating income realized by the developer from the amenity prior to the amenity being sold or transferred should be recorded as a reduction in common costs.
- ▶ If management does not plan to sell or transfer an amenity in connection with the sale of individual units (i.e., management plans to sell the amenity separately or retain the amenity), only capitalizable costs in excess of the estimated fair value of the amenity as of the expected date of its substantial physical completion should be accounted for as common costs and allocated to the individual units based on the relative fair value of each unit before construction (see Section 2.6 for additional guidance on allocating common costs). The costs not allocated to individual units should be capitalized as a separate asset and depreciation of the asset should commence when the amenity is substantially complete and available for use. The costs allocated to the amenity should not be revised after the amenity is substantially completed and available for use. A later sale of the amenity at more or less than its estimated fair value, less any accumulated depreciation, will result in a gain or loss that should be included in net income in the period in which the sale occurs unless previously impaired. Operating income (or loss) of the amenity before it is substantially complete and ready for its intended use should be included as a reduction of (or an addition to) common costs. After the amenity is substantially complete and ready for its intended use, operating income (or loss) should be included in current operating results.

Illustration 2-6: Amenity to be transferred in connection with sale of individual units

Facts:

Developer A's plans for a 100-unit single family home project include the construction of a recreational facility that will be transferred to the homeowners' association once 50 percent of the homes are sold. Costs of constructing the facility are estimated to be \$75,000 and Developer A anticipates incurring \$10,000 in operating losses between the time the facility is substantially completed and available for use, and when it is transferred to the homeowners' association.

Analysis:

Because Developer A plans to transfer the recreational facility in connection with the sale of individual units (i.e., to the homeowners), the \$75,000 in costs incurred to construct the facility should be accounted for as common costs (i.e., proceeds will be zero) and allocated to the individual homes based on the relative fair value of each lot before construction (see Section 2.6 for additional guidance on allocating common costs). Additionally, the \$10,000 in operating losses incurred by Developer A prior to transferring the property to the homeowners should be allocated to the individual homes as common costs.

Illustration 2-7: Amenity to be sold in connection with sale of individual units**Facts:**

Assume the same facts as in Example 1, except that Developer A plans to sell the recreational facility to the homeowners' association for \$30,000.

Analysis:

Because Developer A plans to sell the recreational facility in connection with the sale of individual units, the \$55,000 in costs that are in excess of anticipated proceeds from the sale (\$75,000 costs + \$10,000 in operating losses prior to sale – \$30,000 sales price) should be accounted for as common costs and allocated to the individual homes based on the relative fair value of each lot before construction (see Section 2.6 for additional guidance on allocating common costs).

Illustration 2-8: Amenity to be sold to a third party**Facts:**

Assume the same facts as in Example 1, except that Developer A plans to sell the recreational facility to a third party that will operate the facility for a profit. The estimated fair value of the facility as of the expected date of its substantial physical completion is \$80,000.

Analysis:

Because Developer A plans to sell the recreational facility separately from the sale of individual units and the estimated fair value of the property as of the expected date of its substantial physical completion is more than the estimated construction costs (estimated fair value \$80,000 versus \$75,000 in estimated construction costs), none of the construction costs should be allocated to the individual units. The \$75,000 in construction costs should be recorded as a fixed asset and depreciation should commence once the facility is substantially complete and available for use. When the facility is sold, Developer A should record the difference between the sales price and the book value of the asset, if any, as a gain or loss in the period of sale and not as a common cost to be allocated to the individual homes. Additionally, the \$10,000 in operating losses incurred by Developer A after the property is substantially complete and available for use should not be allocated to the individual homes as common costs, but should be included in current operating results. See ASC 970-340-25-11 for a discussion of operating income or loss of amenities generated prior to the amenities being substantially completed and available for use.

2.5**Incidental operations****Excerpt from Accounting Standards Codification*****Incidental Operations***

Revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate a profit or a return from the use of the property.

Incremental Revenues from Incidental Operations

Revenues that would not be produced except in relation to the conduct of incidental operations.

Incremental Costs of Incidental Operations

Costs that would not be incurred except in relation to the conduct of incidental operations. Interest, taxes, insurance, security, and similar costs that would be incurred during the development of a real estate project regardless of whether incidental operations were conducted are not incremental costs.

Real Estate – General – Other Assets and Deferred Costs***Recognition******970-340-25-12***

Incremental revenue from incidental operations in excess of incremental costs of incidental operations shall be accounted for as a reduction of capitalized project costs. Incremental costs in excess of incremental revenue shall be charged to expense as incurred, because the incidental operations did not achieve the objective of reducing the costs of developing the property for its intended use.

Incidental operations are defined as revenue-producing activities engaged in during the holding or development period to reduce the cost of developing the property for its intended use, as distinguished from activities designed to generate a profit or a return from the use of the property. Incidental operations do not include revenue generated from amenities because amenities are improvements that are developed to increase the value of the project and not reduce the cost of developing the project. The accounting for amenities is described in Section 2.4. Incremental revenue from incidental operations in excess of incremental costs should be accounted for as a reduction of capitalized project costs. If incremental costs exceed incremental revenue, the difference should be charged to expense, and not treated as an increase in capitalized project costs, because the incidental operations did not achieve the objective of reducing the costs of developing the property.

Incremental costs of incidental operations are costs that would not be incurred except in relation to the conduct of incidental operations. Therefore, incremental costs do not include interest, taxes, insurance, security, and other costs that would be incurred during development regardless of whether incidental operations are conducted.

Illustration 2-9: Incidental operations**Facts:**

Developer A is constructing an office building on undeveloped land. To offset the cost of development, Developer A decides to sell the lumber that is cleared from the land for \$50,000. Developer A incurs \$20,000 in costs to clear the land and \$10,000 to identify a buyer and ship the lumber.

Analysis:

Developer A should account for the proceeds from the sale of the lumber in excess of incremental costs as a reduction of capitalized project costs. Because the costs incurred to clear the land would be incurred regardless of whether the lumber was sold or discarded, the \$20,000 in costs to clear the land would not be considered incremental costs. Therefore, the \$50,000 proceeds from the sale less the \$10,000 in incremental costs incurred to identify a buyer and ship the lumber, or \$40,000, should be recorded as a reduction of capitalized project costs. This example presumes the costs to dispose of the timber, were the land simply cleared, which are not incremental costs, are not significant. Because clearing the land to build an office building is clearly associated with the development of a real estate project, the \$20,000 in costs incurred to clear the land should be capitalized as a project cost.

2.6 Allocation of capitalized costs to the components of a real estate project

Excerpt from Accounting Standards Codification

Relative Fair Value Before Construction

The fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of value added by on-site development and construction activities.

Real Estate – General – Property, Plant, and Equipment

Initial Measurement

970-360-30-1

The capitalized costs of real estate projects shall be assigned to individual components of the project based on specific identification. If specific identification is not practicable, capitalized costs shall be allocated as follows:

- a. Land cost and all other common costs, including the costs of amenities to be allocated as common costs per paragraphs 970-340-25-9 through 25-11 (before construction), shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction.
- b. Construction costs shall be allocated to individual units in the phase on the basis of relative sales value of each unit.

If allocation based on relative value also is impracticable, capitalized costs shall be allocated based on area methods (for example, square footage) or other value methods as appropriate under the circumstances.

Because components of a real estate project are often sold separately (e.g., the sale of individual homes in a housing development), costs capitalized for preacquisition costs, property taxes, insurance and amenities must be allocated to the individual components of a real estate project. If capitalized costs of a project are specifically related to an individual component of the project (e.g., the cost of constructing an individual home), the costs should be assigned to that component. If specific identification is not practicable, capitalized costs should be allocated as follows:

- ▶ Land cost and all other common costs incurred prior to construction should be allocated to each land parcel benefited based on the relative fair value of the parcel before construction. Common costs may include the cost of amenities (see Section 2.4) and infrastructure, such as sewer and water lines, drainage systems, roads, and sidewalks. If it is possible to specifically identify these costs with a smaller component of the project rather than the entire project (e.g., one street within a housing development versus the main entry to a master planned community), costs should first be allocated to the smaller component, and then allocated to individual units based on the relative fair value before construction.

A land parcel may be considered to be an individual lot or unit, an amenity, or a **phase**. The fair value of a parcel is affected by its physical characteristics, its highest and best use, and the time and cost required for the buyer to make such use of the property considering access, development plans, zoning restrictions, and market absorption factors (ASC 970-340-25-10 – see Section 2.4).

- ▶ Construction costs should be allocated to individual units in a phase based on the relative sales value of each unit. Because all units may not be ready for sale at the same time, it may be necessary to estimate the sales value of the unfinished units to properly allocate capitalized costs to all units.
- ▶ If allocation based on specific identification and relative value is impracticable, capitalized costs shall be allocated based on area methods, such as acreage or square footage, or other value methods as appropriate under the circumstances.

The guidance for real estate project costs indicates that land and all other common costs incurred prior to construction, including the cost of amenities, should be allocated to each *land parcel* benefited based on the relative fair value before construction. However, it is unclear how this guidance should be applied to the construction of condominium units or other structures that include more than one unit on the same land parcel. It is often impracticable to allocate costs to these units based on their relative fair value before construction, because the units do not exist before construction. Therefore, because the guidance for real estate project costs indicates that area methods or other value methods should be used if allocation based on relative value is impracticable, we believe it would generally be appropriate to allocate land and common costs to these types of structures based on the relative sales value of each unit after construction. Whenever possible, costs should be allocated so that there is a consistent profit margin on the sale of individual units.

Illustration 2-10: Allocation of costs to project components

Facts:

Company A purchases land zoned for residential use for \$320,000. Company A's plans for the land include 50 single-family homes and a swimming pool that will be transferred to the homeowners' association once 50 percent of the homes are sold. Company A estimates that it will incur \$10,000 in costs to build the swimming pool and \$90,000 in other common costs not directly associated with individual homes for sewer lines, roads, and sidewalks. Company A determined the fair value (considering the criteria in ASC 820, *Fair Value Measurements and Disclosures*) of 30 of the 50 half acre lots is \$10,000 per lot (\$300,000 in total) and the fair value of 20 of the 50 half acre lots is \$20,000 per lot (\$400,000 in total).

Analysis:

Company A should allocate the common costs (\$100,000) and land cost (\$320,000) based on the relative fair value of each parcel of land before construction. Each lot valued at \$10,000 should be allocated \$6,000 in costs ($\$10,000 \text{ individual value} / \$700,000 \text{ total value} \times \$420,000 \text{ total costs}$) and each lot valued at \$20,000 should be allocated \$12,000 in costs ($\$20,000 \text{ individual value} / \$700,000 \text{ total value} \times \$420,000 \text{ total costs}$).

As noted above, whenever possible, costs should be allocated so that there is a consistent profit margin on the sale of individual units. If the lots were sold before construction of the homes, the sale of each lot would result in profit of \$4,000 on the \$10,000 lots and \$8,000 on the \$20,000 lots, for a consistent profit margin of 40 percent on all lots. In contrast, if each lot instead was allocated an equal share of the costs based on an area method (assuming all of the lots are the same size), each lot would be allocated \$8,400 in costs and the sale of the \$10,000 lots would result in a 16 percent profit margin, while the sale of the \$20,000 lots would result in 58 percent margin.

Although not specifically mentioned in the guidance for real estate project costs, we believe the above guidance primarily relates to real estate developed for sale versus real estate developed for rent. Because individual units in a rental project are not for sale, it is not generally necessary to allocate costs among the units. If allocation of capitalized costs is necessary (e.g., because the individual floors in an office building will not all be available for lease at the same time – see Section 3.3), an area method should be used to allocate costs. This allocation will generally be limited to land and project costs, such as the overall cost of the building. The cost of an amenity should be capitalized as a separate asset and depreciation of the asset should commence when the amenity is substantially complete and available for use (see Section 2.4 for additional information on accounting for amenities).

2.7 Revisions of estimates

Excerpt from Accounting Standards Codification

Real Estate – General – Other Assets and Deferred Costs

Subsequent Measurement

970-340-35-1

Estimates and cost allocations shall be reviewed at the end of each financial reporting period until a project is substantially completed and available for sale. Costs shall be revised and reallocated as necessary for material changes on the basis of current estimates. Paragraph 976-605-35-1, discusses revisions of estimates relating to retail land sales accounted for by the percentage-of-completion method. Changes in estimates shall be reported in accordance with paragraphs 250-10-45-17 through 45-20 and 250-10-50-4.

Changes in estimates are a common occurrence in real estate projects. As work progresses and experience is gained, original estimates often change even though the scope of the work required may not change.

Changes in estimates should be accounted for in accordance with ASC 250, *Accounting Changes and Error Corrections*, and should be recorded in (a) the period of change if the change affects that period only or (b) the period of change and future periods if the change affects both. A change in accounting estimate should not be accounted for by restating or retrospectively adjusting amounts previously reported in financial statements of prior periods or by reporting pro forma amounts for prior periods.

2.8 Abandonments

Excerpt from Accounting Standards Codification

Real Estate – General – Property, Plant, and Equipment

Derecognition

970-360-40-1

If real estate, including rights to real estate, is abandoned (for example, by allowing a mortgage to be foreclosed or a purchase option to lapse), capitalized costs of that real estate shall be expensed. Such costs shall not be allocated to other components of the project or to other projects.

If a real estate project is abandoned during the preacquisition phase, the guidance in Section 2.1 should be applied (i.e., all costs not recoverable through the sale of options, plans, etc., should be charged to expense when it is probable the property will not be acquired). If a project is expected to be abandoned after the property has been acquired, prior to abandonment, companies should evaluate any asset recorded for impairment in accordance with the guidance for impairment and disposal of long-lived assets (ASC 360-10).

2.9 Donations to municipalities

Excerpt from Accounting Standards Codification

Real Estate – General – Property, Plant, and Equipment

Subsequent Measurement

970-360-35-1

Real estate donated to municipalities or other governmental agencies for uses that will benefit the project are not abandonments. The cost of the real estate donated shall be allocated as a common cost of the project.

Real estate donated to governmental agencies for uses that will benefit the project (e.g., land donated to be used as a city park in a housing development) should not be accounted for as abandoned real estate. Instead, the cost of the real estate donated should be allocated to the individual units of the project as a common cost of the project (see Section 2.6 for guidance on allocation of common costs). We believe the guidance for real estate projects costs applies to real estate donated to governmental agencies.

Illustration 2-11: Land donated to governmental agency

Facts:

Company A purchases land zoned for residential use for \$400,000. Company A's plans for the land include 50 single-family homes and a park. Company A gives the land designated for the park to the city to develop the park.

Analysis:

Because the land donated to the city will benefit the housing project, the entire \$400,000 cost of the land, which includes the cost of the donated land, should be allocated to the individual units of the project based on the relative fair value of each unit (see Section 2.6 for allocation guidance). It is not necessary for Company A to separately value the land donated to the city and account for it as abandoned real estate.

Alternatively, a developer may give land to a commercial enterprise on the condition that the enterprise builds and operates a facility on the land because the enterprise is well-established and will attract other buyers/tenants to the project. We believe this transaction is most appropriately accounted for as a nonmonetary exchange of land for an intangible asset.

Illustration 2-12: Land given to a commercial enterprise

Facts:

Developer A is in the process of constructing a shopping mall. To attract other retailers to the shopping mall, Developer A enters into an agreement with High Traffic Retailer. In exchange for High Traffic Retailer agreeing to operate one of its stores in the shopping mall for at least 20 years, Developer A gives High Traffic Retailer the land on which the store will be built. If High Traffic Retailer does not operate the store for at least 20 years, the land will revert back to Developer A.

Analysis:

The exchange of land for an intangible asset (the operation of a High Traffic store for at least 20 years) is a nonmonetary transaction that should be accounted for in accordance with ASC 845, Nonmonetary Transactions (refer to our Financial Reporting Developments booklet, Real Estate Sales). The intangible asset recorded as a result of the exchange should be amortized and assessed for impairment in accordance with ASC 350, *Intangibles – Goodwill and Other*.

Developers enter into a variety of arrangements with commercial enterprises, some of which we have highlighted herein. In all instances an understanding of the rights and obligations exchanged is necessary to determine the appropriate accounting guidance (such as the guidance for real estate sales transactions, real estate project costs, business combinations or nonmonetary transactions) to apply, as well as the related application of that guidance.

2.10 Changes in use

Excerpt from Accounting Standards Codification

Real Estate – General – Property, Plant, and Equipment

Subsequent Measurement

970-360-35-2

Changes in the use of real estate comprising a project or a portion of a project may arise after significant development and construction costs have been incurred. If the change in use is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before change), the development and construction costs to be charged to expense shall be limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

From time-to-time, an entity may decide to change its use of real estate after significant development and construction costs have been incurred (e.g., an entity decides to construct an office building instead of an apartment complex after incurring some of costs to construct the buildings and amenities). If the change in use of real estate during development is made pursuant to a formal plan for a project that is expected to produce a higher economic yield (as compared to its yield based on use before change), the development and construction costs that must be charged to expense are limited to the amount by which the capitalized costs incurred and to be incurred exceed the estimated value of the revised project when it is substantially complete and ready for its intended use.

Whether or not a qualified change in use has or has not occurred, properties under development are subject to impairment under ASC 360-10. When the revised project will generate a higher economic yield, it is unlikely that an incremental impairment beyond that measured in accordance with the guidance for real estate project costs in ASC 970-360-35-2 would exist. If however, the change in use results in a lower economic yield, the likelihood of an impairment increases.

3 Costs incurred to sell and rent real estate

3.1 Costs incurred to sell real estate projects

Excerpt from Accounting Standards Codification

Real Estate – General – Other Assets and Deferred Costs

Recognition

970-340-25-13

Costs incurred to sell real estate projects shall be capitalized if they meet both of the following conditions:

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

970-340-25-14

Examples of costs incurred to sell real estate projects that ordinarily meet the criteria for capitalization are costs of model units and their furnishings, sales facilities, legal fees for preparation of prospectuses, and semi permanent signs.

970-340-25-15

Other costs incurred to sell real estate projects shall be capitalized as prepaid costs if they are directly associated with and their recovery is reasonably expected from sales that are being accounted for under a method of accounting other than full accrual. Topic 976 discusses the circumstances under which the appropriate accounting methods are to be applied, including the full accrual method. Costs that do not meet the criteria for capitalization shall be expensed as incurred.

Derecognition

970-340-40-1

Capitalized selling costs shall be charged to expense in the period in which the related revenue is recognized as earned. When a sales contract is canceled (with or without refund) or the related receivable is written off as uncollectible, the related unrecoverable capitalized selling costs shall be charged to expense or an allowance previously established for that purpose.

Costs incurred to sell real estate may include costs such as model units and their furnishings, sales facilities, sales brochures, legal fees, semipermanent signs, advertising, and sales overhead, including sales salaries. Costs incurred to sell real estate should be capitalized if the costs are recoverable and incurred for (1) tangible assets that are used directly throughout the selling period to aid in the sale of the project or (2) services that have been performed to obtain regulatory approval of sales. Costs that do not meet these criteria, such as advertising, and sales overhead costs, should be charged to expense as incurred.

Selling costs incurred prior to receiving related goods or services should be recorded as prepaid expenses. These costs should be charged to expense in the period in which the related goods or services are received (e.g., in the period an ad is included in a magazine – refer to ASC 720-35, *Other Expenses – Advertising Costs*, for additional guidance).

If a sale is accounted for under a method of accounting other than the full accrual method (refer to the Financial Reporting Developments booklet, *Real Estate Sales*, for a discussion of real estate sales), costs that would not otherwise qualify to be capitalized that are directly associated with the sale (e.g., sales commissions) should be capitalized if recovery of the cost is reasonably expected. We believe the evaluation of the recoverability of sales costs should be the same as that discussed in ASC 360-20, *Property, Plant and Equipment – Real Estate Sales*, to determine whether a transaction should be accounted for using the installment, cost recovery, or deposit method. If a seller is accounting for a transaction using the cost recovery or deposit method because recovery of the cost of the property is not reasonably assured if the buyer defaults or if the cost of the property has already been recovered and collection of additional amounts is uncertain, the seller should not capitalize any selling costs associated with the transaction. Additionally, even if recovery of the cost of the property is reasonably assured if the buyer defaults, if the expected profit on the transaction is less than the selling costs, selling costs in excess of the expected profit should not be capitalized.

Capitalized selling costs should be charged to expense in the period in which the related revenue is recognized. If a sales contract is canceled or the related receivable is written off as uncollectible, capitalized selling costs should also be written off.

Illustration 3-1: Capitalizing costs incurred to sell real estate

Facts:

Company A is in the process of completing a housing project that will include 50 single-family homes. The selling price of each home is \$100,000 and the cost of each home, including allocated common costs, is \$60,000. Company A has incurred costs of \$40,000 for model home furnishings, \$5,000 for semipermanent signs, \$15,000 for advertising (print and radio ads), and \$15,000 for a sales office, which are used throughout the selling process. Additionally, Company A anticipates paying sales commissions of \$2,000 per home. On 15 September 20X2, Company A sells two homes, one to Customer A and one to Customer B. Company A evaluates each sale in accordance with ASC 360-20 and determines that the sale to Customer A should be accounted for using the full accrual method but the sale to Customer B should be accounted for using the installment method.

Analysis:

Costs incurred to sell real estate should be capitalized if the costs are recoverable and incurred for tangible assets that are used directly throughout the selling period to aid in the sale of the project or for services that have been performed to obtain regulatory approval of sales. Therefore, the costs of the model home furnishings, semipermanent signs, and sales office should be capitalized if the costs are recoverable through the sale of the homes in the project. Because the total estimated profit on the project of \$2 million ($(\$100,000 \text{ sales price} - \$60,000 \text{ cost}) \times 50 \text{ homes}$) is in excess of the \$60,000 cost of the furnishings, signs, and sales office, these permitted selling costs should be capitalized. The capitalized costs should be allocated to each home (see Section 2.6) and charged to expense in the period revenue is recognized for each home (i.e., costs allocated to the home sold to Customer A should be charged to expense on September 15 when the sale is recognized, while costs allocated to the home sold to Customer B should be charged to expense over time, as profit is recognized under the installment method).

The advertising and commission costs do not qualify for capitalization under ASC 970-340-25-13 as they were not incurred for tangible assets or for services that have been performed to obtain regulatory approval of sales. However, selling costs directly associated with the sale of a home accounted for by a method other than the full accrual method should be capitalized as prepaid costs in accordance with ASC 970-340-25-15. Therefore, selling costs directly related to the home sold to Customer B (i.e., the \$2,000 sales commission) should be capitalized. All other costs (advertising costs in this example) should be charged to expense as incurred.

3.2

Costs incurred to rent real estate projects

Excerpt from Accounting Standards Codification

Real Estate – General – Other Assets and Deferred Costs

Recognition

970-340-25-16

If costs incurred to rent real estate projects, other than initial direct costs, under operating leases are related to and their recovery is reasonably expected from future rental operations, they shall be capitalized. Examples are costs of model units and their furnishings, rental facilities, semipermanent signs, grand openings, and unused rental brochures. Costs that do not meet the criteria for capitalization shall be expensed as incurred, for example, rental overhead. Initial direct costs are defined in Topic 310 and the accounting for initial direct costs is prescribed in Subtopic 840-20.

Subsequent Measurement

970-340-35-2

Capitalized rental costs directly related to revenue from a specific operating lease shall be amortized over the lease term. Capitalized rental costs not directly related to revenue from a specific operating lease shall be amortized over the period of expected benefit. The amortization period shall begin when the project is substantially completed and held available for occupancy. See paragraphs 970-605-25-1 through 25-2 for the definition of substantially completed and held available for occupancy.

Derecognition

970-340-40-2

Estimated unrecoverable amounts of unamortized capitalized rental costs associated with a lease or group of leases shall be charged to expense when it becomes probable that the lease(s) will be terminated.

Costs incurred to rent real estate may include costs such as model units and their furnishings, rental facilities, rental brochures, semipermanent signs, advertising, “grand openings” to attract tenants, initial direct costs of lease origination, and rental overhead, including rental salaries. The guidance for real estate project costs does not address the accounting for initial direct costs to rent real estate projects. Initial direct costs include (a) incremental direct costs of lease origination incurred in transactions with independent third parties for that lease and (b) certain costs directly related to specified activities performed by the lessor for that lease. Initial direct costs, such as costs of preparing and processing lease documents and negotiating lease terms, should be accounted for in accordance with ASC 840, *Leases*. Refer to our Financial Reporting Developments booklet, *Lease Accounting – A Summary*, for guidance on accounting for initial direct costs of leases.

Rental costs that are not initial direct costs should be charged to expense as incurred, unless the costs are related to and their recovery is reasonably expected from future rental operations of operating leases. Rental costs that would generally qualify for capitalization include costs of model units and their furnishings, rental facilities, semipermanent signs, “grand openings” to attract tenants, and unused rental brochures. Rental overhead costs do not qualify to be capitalized as rental costs and should be charged to expense as incurred.

Illustration 3-2: Costs incurred to rent real estate projects

Facts:

Company A has leased substantially all space in a retail shopping center. To assure the success of the facility, and in turn, higher future rentals, Company A holds a “grand opening” celebration to attract customers to tenants of the center.

Analysis:

Although attracting customers to the shopping center may result in higher future rentals for Company A, costs incurred by Company A to carry out a grand opening to attract customers to the shopping center are not costs incurred to rent real estate. Therefore, the costs associated with the grand opening should be charged to expense as incurred. If, prior to leasing substantially all the space in the shopping center, Company A held a grand opening to attract tenants to the center, the costs associated with the grand opening would be capitalizable to the extent their recovery was reasonably expected from future rental operations.

Rental costs capitalized in accordance with the guidance for real estate project costs that are not directly related to a specific operating lease should be amortized over the period of expected benefit (ASC 970-340-25-16). Capitalized rental costs that are directly related to a specific operating lease should be amortized over the lease term as defined in ASC 840. Because all initial direct costs must be accounted for in accordance with ASC 840, most rental costs that qualify for capitalization in accordance with ASC 970-340-25-16 will not directly relate to a specific operating lease (e.g., the costs of a rental facility benefit an entire rental project and not one specific operating lease) and should be amortized over the period of expected benefit.

ASC 970 does not provide guidance on determining the period of expected benefit of capitalized rental costs. The guidance for real estate project costs indicates that the amortization period should begin when the project is substantially completed and held available for occupancy (see Section 3.3 for further discussion of when a project is substantially completed and held available for occupancy). We believe the period of expected benefit should not exceed the average term of leases in place at the time amortization begins.

Capitalized rental costs should be evaluated for recoverability when it becomes probable that a lease or group of leases will be terminated. Costs that are deemed to be unrecoverable should be charged to expense when it becomes probable that the lease(s) will be terminated.

3.3

Initial rental operations**Excerpt from Accounting Standards Codification****Real Estate – General – Revenue Recognition***Recognition***970-605-25-1**

When a real estate project is substantially completed and held available for occupancy:

- a. Rental revenues and operating costs shall be recognized in income and expense as they accrue.
- b. All carrying costs (such as real estate taxes) shall be charged to expense when incurred, depreciation on the cost of the project shall be provided.
- c. Costs to rent the project shall be amortized in accordance with paragraph 970-340-35-2 and 970-340-40-2.

970-605-25-2

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 (as distinguished from activities such as routine maintenance and cleanup).

Real Estate – General – Other Assets and Deferred Costs*Recognition***970-340-25-17**

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 shall 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.

When a rental property is substantially completed and held available for occupancy, no new carrying costs should be capitalized (e.g., taxes and insurance costs should be charged to expense as incurred), and the developer should begin depreciating costs previously capitalized. Rental revenues and operating costs should be recognized as they accrue. In addition, interest should no longer be capitalized in accordance with ASC 835-20.

The period over which capitalized costs should be depreciated will depend on the nature of the costs. As discussed in Section 3.2, rental costs that are not directly related to revenue from a specific operating lease should be amortized over the period of expected benefit. Rental costs that are directly related to revenue from a specific operating lease should be amortized over the related lease term (i.e., the lease term for accounting purposes under ASC 840). Development and construction costs should be depreciated over the useful life of the property and costs of lessor owned tenant improvements should be depreciated over the expected life of the improvements. Tenant improvements that do not provide value beyond the current lease term (e.g., customized improvements that only the current tenant can utilize) should be amortized over the shorter of their useful lives or the lease term. Amenities retained by the landlord should be depreciated over their estimated useful lives.

A property may be substantially completed and held available for occupancy in phases (e.g., by floor in an office building or by wing in a shopping center). When a property is completed in phases, each phase should be accounted for as a separate project. Costs should be allocated between the portions under construction and the portions substantially completed and held available for occupancy, and the developer should begin recording depreciation on each portion as it is substantially completed and held available for occupancy.

The majority of the costs that must be allocated in a rental project are acquisition and construction costs (e.g., cost of constructing an office building if each floor is considered a separate phase). These costs should generally be allocated on an area method, such as square footage (see Section 2.6 for additional discussion of cost allocations). It is not necessary to allocate the cost of land and amenities, such as swimming pools and parking facilities, because these items should be recorded by the developer and, in the case of depreciable assets, depreciated as separate assets (see Section 2.4 for discussion of amenities that will be retained by the developer). If an entity does allocate such costs, it is important that the allocation of depreciable assets be factored into the determination of estimated useful lives and salvage values and that non-depreciable assets (e.g., land) be accounted for separately.

A real estate project should be considered substantially completed and held available for occupancy when tenant improvements are completed by the developer but no later than one year after the completion of major construction activities (even if tenant improvements are not completed). The developer should begin depreciating capitalized costs and cease capitalizing new costs, including taxes, insurance, and rental costs. Additionally, although the guidance for the capitalization of interest does not include the term “substantially completed and held available for occupancy,” we believe interest capitalization would generally cease at the same point as capitalization of costs for real estate projects.

As discussed above, a project may be considered substantially completed and held available for occupancy in phases (e.g., a high rise office building where tenants occupy the building in stages). Therefore, companies should not postpone recording depreciation on a project until all tenant improvements have been completed or the one-year time period has passed if the project can be separated into smaller projects. These smaller projects should be separately evaluated and depreciation should commence for each project once it is substantially completed and held available for occupancy.

Illustration 3-3: Apartment complex with multiple buildings

Facts:

Company A is building an apartment complex that will include three apartment buildings (Buildings A, B and C), a clubhouse, two tennis courts, and a pool. Each apartment building is identical and costs \$500,000 to construct. Company A estimates that the clubhouse, tennis courts, and pool will cost \$60,000, which approximates their estimated fair value as of the expected date of substantial physical completion. Company A has incurred \$24,000 in capitalizable rental costs related to a rental office and semipermanent signs. Company A completes construction of Building A on 15 January 20X6. Tenants begin moving into the apartments in Building A on 1 February 20X6. Building B and the clubhouse, tennis courts, and pool are completed on 1 June 20X6, and Building C is completed on 1 February 20X7.

Analysis:

Because the buildings in the apartment complex are completed and held available for occupancy in stages, each building should be accounted for as a separate project. Building A would be considered substantially completed and held available for occupancy on 15 January 20X6 and Company A should begin depreciating costs associated with Building A at that time.

Company A should begin depreciating costs associated with Building B and Building C and the rental costs allocated to each building as they are completed and held available for occupancy on 1 June 20X6 and 1 February 20X7, respectively. Costs associated with the clubhouse, tennis courts, and pool, which will be retained and operated by Company A, should not be allocated to the buildings, but should be recorded as separate assets. Depreciation of these assets should commence on 1 June 20X6.

Illustration 3-4: Shopping mall completed in stages**Facts:**

Developer A is constructing a shopping mall that will contain three wings (Wings A, B, and C). Estimated development costs include \$10 million to construct the building plus an additional \$10,000 per tenant in tenant improvements. Developer A completes construction of the building and all common areas and tenant improvements for Wing A on 15 June 20X7. The walkways and bathrooms in Wing B and Wing C are not completed until 15 August 20X7, and the wings were not permitted to open until that work was completed. Tenant improvements for Wing B are completed on 15 July 20X8, and Wing C tenant improvements are completed on 15 September 20X8.

Analysis:

Because the shopping mall is completed and held available for occupancy in stages, each wing in the mall should be accounted for as a separate project. The following table summarizes the timing of the completion of each wing and the date each wing would be considered substantially completed and held available for occupancy.

Wing	Cessation of major construction	Completion of tenant improvements	Date substantially completed and held available for occupancy
A	15 June 20X7	15 June 20X7	15 June 20X7
B	15 August 20X7	15 July 20X8	15 July 20X8
C	15 August 20X7	15 September 20X8	15 August 20X8

Because all major construction and tenant improvements are completed for Wing A on 15 June 20X7, Wing A would be considered substantially completed and held available for occupancy on that date. The \$10 million in costs incurred to construct the building should be allocated to each wing in the mall based on the leasable square footage of each wing. Developer A should begin depreciating the costs allocated to Wing A on 15 June 20X7 over the estimated useful life of the building. Tenant improvements should be depreciated over the estimated useful life of the improvements.

Major construction activity on Wings B and C would be considered complete on 15 August 20X7 when all common areas are complete. Because tenant improvements are completed for Wing B on 15 July 20X8, Wing B would be considered substantially completed and held available for occupancy on 15 July 20X8. Because tenant improvements for Wing C are completed more than one year after the completion of major construction activity on 15 September 20X8, Wing C would be considered substantially completed and held available for occupancy on 15 August 20X8 (one year after the cessation of major construction activity).

4

Recoverability

Excerpt from Accounting Standards Codification

Real Estate – General – Property, Plant, and Equipment

Subsequent Measurement

970-360-35-3

The provisions in Subtopic 360-10 for long-lived assets to be disposed of by sale shall apply to a real estate project, or parts thereof, that is substantially completed and that is to be sold. The provisions in that Topic for long-lived assets to be held and used shall apply to real estate held for development, including property to be developed in the future as well as that currently under development, and to a real estate project, or parts thereof, that is substantially completed and that is to be held and used (for example, for rental). Determining whether the carrying amounts of real estate projects require recognition of an impairment loss shall be based on an evaluation of individual projects. An individual project, for this purpose, consists of components that are relatively homogeneous, integral parts of a whole (for example, individual houses in a residential tract, individual units in a condominium complex, and individual lots in a subdivision and amenities). Therefore, a multiphase development consisting of a tract of single-family houses, a condominium complex, and a lot subdivision generally would be evaluated as three separate projects.

970-360-35-4

Paragraph 360-10-35-21 provides examples of events or changes in circumstances that indicate that the recoverability of the carrying amount of a long-lived asset should be assessed. Insufficient rental demand for a rental project currently under construction is an additional example that indicates that the recoverability of the real estate project should be assessed in accordance with the provisions of Subtopic 360-10.

Capitalized costs of real estate projects are subject to the guidance for impairment of long-lived assets (ASC 360-10). Real estate projects, or parts of projects, that will be sold that are substantially completed should be accounted for as long-lived assets to be disposed of by sale in accordance with ASC 360-10. Real estate projects that are currently under development, property that is being held for development in the future, and real estate projects that are substantially completed that will be held and used (i.e., real estate developed for rent) should be accounted for as long-lived assets to be held and used and should be evaluated for impairment when events or changes in circumstances indicate that carrying amount may not be recoverable, including during construction. In addition to the impairment indicators identified in ASC 360-10 (i.e., the indicators identified in ASC 360-10-35-21), factors specific to real estate, such as insufficient rental demand for a rental project, a decline in market conditions for property to be sold (e.g., a condominium complex), and a delay in development due to market or regulatory conditions, should be considered.

See our Ernst & Young Financial Reporting Developments booklet, *Impairment or disposal of long-lived assets*, for guidance on the impairment and disposal of long-lived assets.

A

Index of ASC references in this publication

ASC Paragraph	Chapter/Section	
970-10-05-6	1	Introductions and scope
970-10-15-7	1	Introductions and scope
970-10-15-8	1	Introductions and scope
970-10-15-9	1	Introductions and scope
970-10-15-10	1	Introductions and scope
970-10-15-11	1.1	General
970-340-25-3	2.1	Preacquisition costs
970-340-25-4	2.1	Preacquisition costs
970-340-25-5	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-340-25-6	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-340-25-7	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-340-25-8	2.2	Taxes and insurance
970-340-25-9	2.4	Amenities
970-340-25-10	2.4	Amenities
970-340-25-11	2.4	Amenities
970-340-25-12	2.5	Incidental operations
970-340-25-13	3.1	Costs incurred to sell real estate projects
970-340-25-14	3.1	Costs incurred to sell real estate projects
970-340-25-15	3.1	Costs incurred to sell real estate projects
970-340-25-16	3.2	Costs incurred to rent real estate projects
970-340-25-17	3.3	Initial rental operations
970-340-35-1	2.7	Revisions of estimates
970-340-35-2	3.2	Costs incurred to rent real estate projects
970-340-35-3	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-340-35-4	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-340-40-1	3.1	Costs incurred to sell real estate projects
970-340-40-2	3.2	Costs incurred to rent real estate projects
970-360-25-2	2.3	Project costs
970-360-25-3	2.3	Project costs
970-360-30-1	2.6	Allocation of capitalized costs to the components of a real estate project
970-360-35-1	2.9	Donations to municipalities
970-360-35-2	2.10	Changes in use
970-360-35-3	4	Recoverability
970-360-35-4	4	Recoverability
970-360-40-1	2.8	Abandonments

ASC Paragraph	Chapter/Section	
970-470-05-2	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-05-3	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-25-1	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-25-2	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-25-3	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-25-4	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-25-5	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-2	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-3	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-4	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-5	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-6	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-7	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-8	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-9	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-10	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-11	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-12	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-13	2.2.1	Accounting for special assessments and tax increment financing entities
970-470-55-14	2.2.1	Accounting for special assessments and tax increment financing entities
970-605-25-1	3.3	Initial rental operations
970-605-25-2	3.3	Initial rental operations
970-720-25-1	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-720-25-2	2.1.1	Accounting for internal costs relating to real estate property acquisitions
970-720-25-3	2.3	Project costs

B Abbreviations used in this publication

Abbreviation	FASB Accounting Standards Codification
ASC 250	FASB ASC Topic 250, Accounting Changes and Error Corrections
ASC 350	FASB ASC Topic 350, Intangibles – Goodwill and Other
ASC 360-10	FASB ASC Subtopic 360-10, Property, Plant, and Equipment – Overall
ASC 360-20	FASB ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales
ASC 410-20	FASB ASC Subtopic 410-20, Asset Retirement and Environmental Obligations – Asset Retirement Obligations
ASC 410-30	FASB ASC Subtopic 410-30, Asset Retirement and Environmental Obligations – Environmental Obligations
ASC 450	FASB ASC Topic 450, Contingencies
ASC 450-20	FASB ASC Subtopic 450-20, Contingencies – Loss Contingencies
ASC 460	FASB ASC Topic 460, Guarantees
ASC 720-35	FASB ASC Subtopic 720-35, Other Expenses – Advertising Costs
ASC 805	FASB ASC Topic 805, Business Combinations
ASC 810	FASB ASC Topic 810, Consolidations
ASC 820	FASB ASC Topic 820, Fair Value Measurements and Disclosures
ASC 835-20	FASB ASC Subtopic 835-20, Interest – Capitalization of Interest
ASC 840	FASB ASC Topic 840, Leases
ASC 845	FASB ASC Topic 845, Nonmonetary Transactions
ASC 970	FASB ASC Topic 970, Real Estate – General
ASC 970-470	FASB ASC Subtopic 970-470, Real Estate – General – Debt
ASC 978	FASB ASC Topic 978, Real Estate – Time-Sharing Activities
Statement 67	FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects

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SCORE no. BB1883

(Revised July 2011)

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