

PROPOSED FASB STAFF POSITION

No. FAS 13-b

Title: Accounting for Rental Costs Incurred during a Construction Period

Comment Deadline: August 18, 2005

Introduction

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) to address the accounting for rental costs associated with operating leases that are incurred during a construction period.

Background

2. In some lease arrangements, an entity (lessee) may take possession of or be given control of leased property before it commences operations or makes rental payments under the terms of the lease. The leased property may include both land and building(s). During this period, the lessee has the right to use the leased property and does so for the purpose of constructing a lessee asset (for example, leasehold improvements). After construction is completed, the lessee commences operations and is required to make rental payments under the terms of the lease. Alternatively, some lease arrangements require the lessee to make rental payments when the lessee takes possession of or is given control of the leased property.

3. FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, requires that rental costs associated with operating leases be allocated on a straight-line basis in accordance with FASB Statement No. 13, *Accounting for Leases*, and FASB Technical Bulletin No. 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, starting with the beginning of the lease term.¹

¹ The *lease term* begins when the lessee takes possession of or is given control of the leased property. The beginning of the lease term may be different from the *inception of the lease*, which is used for purposes of lease classification. Inception of the lease is defined in paragraph 6 of FASB Statement No. 23, *Inception of the Lease*, as “the date of the lease agreement or commitment, if earlier. For purposes of this definition, a commitment shall be in writing, signed by the parties in interest to the transaction, and shall specifically set forth the principal provisions of the transaction. If any of the principal provisions are yet to be negotiated, such a preliminary agreement or commitment does not qualify for purposes of this definition.”

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

5. Questions have arisen as to whether rental costs associated with ground and building operating leases that are allocated to the period of construction of a lessee asset that is directly related to the leased property may be capitalized (that is, rental costs incurred during a construction period). This FSP addresses whether a lessee may capitalize rental costs incurred during a construction period and, if so, the types of rental costs that can be capitalized. This FSP does not address rental costs other than those associated with building and ground operating leases.²

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6. Rental costs incurred during and after a construction period are for the right to control the use of a leased asset during and after construction of a lessee asset.³ There is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Therefore, rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. The rental costs shall be included in income from continuing operations. A lessee shall follow the guidance in Statement 13 and Technical Bulletin 85-3 in determining how to allocate rental costs over the lease term.

² Paragraph 2 of FASB Statement No. 34, *Capitalization of Interest Cost*, addresses the accounting for interest expense associated with capital leases.

³ Paragraph 12 of EITF Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," states that "an arrangement conveys the *right to use* property, plant, or equipment if the arrangement conveys to the purchaser (lessee) the right to control the use of the underlying property, plant, or equipment."

Effective Date and Transition

7. The guidance in this FSP shall be applied to the first reporting period beginning after September 15, 2005. A lessee shall cease capitalizing rental costs as of the effective date of this FSP for operating lease arrangements entered into prior to the effective date of this FSP. Retrospective application is permitted but not required.