PHILIPPINE INTERPRETATIONS COMMITTEE (PIC)
QUESTIONS AND ANSWERS (Q&As)

Q&A No. 2017-02

PAS 2 and PAS 16 - Capitalization of operating lease cost as part of construction costs of a building

Issue

Do operating lease costs (i.e., rentals or amortization of lease prepayments) constitute part of the cost of:

1. Constructing a building that is accounted for under PAS 2, *Inventories*, and will be sold?
2. Constructing a building that is accounted for under PAS 16, *Property, Plant and Equipment*, and will be for own use?
3. Leasehold improvements to a building that is held for own use?

Fact Pattern

Scenario 1 – land is leased and building is constructed to be held for sale

On January 1, 20X0, an entity enters into an operating lease of land for a term of 20 years. Under the lease agreement, the entity makes an initial upfront payment of ₱1,000 and pays rent of ₱200 quarterly in advance.

The entity intends to construct a building on the land and, as part of its ordinary business activities, plans to sell the building once construction is completed. However, the entity must obtain planning permission for the building, and this process takes three years. Construction of the building begins on January 1, 20X3 and is completed in two years.

The building is sold but the lease of land is retained by the entity. The entity intends to sub-lease the land to the buyer of the building for the rest of its lease term with the landowner[1].

[1] In the absence of such intent, there may arise an issue of whether there is an onerous contract for the remaining lease term which will have to be assessed under PAS 37; or once PFRS 16 takes effect under which a right of use asset will have to be recognized by the lessee, such asset will have to be assessed under PAS 36 for possible impairment. Moreover, in the absence of such an intent (i.e., no subsequent sub-lease arrangement to the buyer of the building), there may be a need to assess if the selling price of the building contains an element intended to cover for the cost of future rentals which may have to be accounted for separately under PFRS 15.

Scenario 2 – land is leased and a building is constructed that will be owner-occupied

Fact pattern is the same as Scenario 1, except that the entity plans to occupy the building itself once construction is completed.

The entity applies the cost model for its property, plant, and equipment.

Scenario 3 – building is leased and leasehold improvements are made

On January 1, 20X0, the entity enters into a 10-year lease of a building at a rent of ₱200 payable quarterly in advance.

To make the building suitable for its requirements, the entity makes substantial leasehold improvements at the beginning of the lease (i.e., first quarter of 20X0). During this time, the building must be vacant and the entity can only move in after the work is completed. On April 1, 20X0, the entity moves into the property.

Consensus and Basis for Consensus

Scenario 1

<u>View 1: Capitalize as part of construction costs</u>

The entity intends to hold the building for sale in the ordinary course of business; therefore, the building meets the definition of inventories under paragraph 6 of PAS 2.

Paragraph 10 of PAS 2 states:

“The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition”.

Paragraph 15 of PAS 2 states:

“Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. [...]”

As the entity enters into the lease with the intention of constructing the building, the lease costs during the construction period are "costs that are incurred in bringing the inventories to their present location and condition.”

View 2: Expense as incurred

The operating lease expenses are for the right to control the use of the leased asset (i.e., the land). As 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, an entity recognizes the operating lease costs as an expense. That is, because the lease payments are not incremental, and must be paid regardless of whether the building is constructed, they cannot be a direct cost of the asset.

Scenario 2

View 1: Capitalize as part of construction costs

Paragraph 22 of PAS 16 states:

"[...] If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see PAS 2)".

Accordingly, the same principles that apply to the construction of an asset held for sale also apply to the construction of an asset that will be owner-occupied.

However, there are additional arguments that support the capitalization of rental expense incurred during the construction period:

Rent is a directly attributable cost in the terms of paragraph 16(b) of PAS 16, which states that the cost of property, plant and equipment comprises (among other things):

"costs directly attributable to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management."

In particular, in the scenario indicated, rent is an unavoidable cost of developing the property, because without this lease no construction can occur.

View 2: Expense as incurred

Refer to View 2 set out for Scenario 1 - operating lease expenses are not a directly attributable cost in terms of paragraph 16(b) of PAS 16, as the entity will have incurred these expenses anyway, irrespective of whether construction of the building started. Therefore, these costs are not capitalized as part of the construction cost of the building.

Since paragraph 22 of PAS 16 refers to PAS 2, whichever policy is selected it must be applied consistently to transactions of the type described in both Scenario 1 and Scenario 2.

Scenario 3

Refer to the reasons for conclusion provided for the Scenarios 1 and 2 above; therefore, in principle, there are arguments that support both accounting policies – capitalizing OR expensing operating lease payments.

However, in this scenario there are additional arguments for expensing operating lease payments. Under this scenario, lease payments are for the right to use the existing building itself (whereas in Scenarios 1 and 2, the building does not yet exist). The way in which an entity uses a building, for example, by making leasehold improvements or by using the building in its current state, does not affect the expenses incurred for the right to use it. If one follows this argument, the entity recognizes the costs for the operating lease as expenses as incurred. However, in this case, the building must be vacant while the leasehold improvements are made, which provides support for capitalization of the lease costs during the period in which the building is not being used.

Accordingly, either accounting policy is permitted but must be applied consistently.

Effective Date

The consensus in this Q&A is effective from the date of approval by the FRSC.

Date approved by PIC: June 28, 2017

(Original signed)

PIC Members

Wilson P. Tan, Chairman

Emmanuel Y. Artiza	**Sharon G. Dayoan**
Clark Joseph L. Babor	**Zaldy D. Aguirre**
Wilfredo A. Baltazar	**Ferdinand George A. Florendo**
Gloria T. Baysa	**Jose Emmanuel U. Hilado**
Rosario S. Bernaldo	**Lyn I. Javier**
Maria Isabel E. Comedia	**Ma. Concepcion Y. Lupisan**
Jerome Antonio B. Constantino	**Normita L. Villaruz**

Date approved by FRSC: December 13, 2017