~~EXPOSURE DRAFT~~

~~PROPOSED~~ STATEMENT OF POSITION

ACCOUNTING FOR CERTAIN COSTS AND ACTIVITIES

RELATED TO PROPERTY, PLANT, AND EQUIPMENT

~~JUNE 29, 2001~~

Prepared by the Accounting Standards Executive Committee
American Institute of Certified Public Accountants

~~**Comments should be received by October 15, 2001, and addressed to Marc Simon, Technical Manager, Accounting Standards, File 4210.CC, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775, or via the Internet to msimon@aicpa.org**~~

~~June 29, 2001~~

~~Accompanying this letter is an exposure draft of a proposed AICPA Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. A summary of the proposed SOP follows this letter.~~

~~The purpose of this exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.~~

~~The proposed SOP provides guidance on accounting for certain costs and activities related to property, plant, and equipment in financial statements prepared in conformity with generally accepted accounting principles (GAAP).~~

~~Concurrent with the issuance of this proposed SOP, the Financial Accounting Standards Board (FASB) is issuing an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment*, that would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*; FASB Statement No. 51, *Financial Reporting by Cable Television Companies*; Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*; and APB Opinion 28, *Interim Financial Reporting*. It also would rescind FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*. The proposed amendments to FASB Statement No. 67 would exclude from the scope of that Statement the accounting for acquisition, development, and construction costs of real estate developed by an entity for rental. The proposed amendments to FASB Statement No. 51 would make the accounting for certain plant and overhead costs in paragraph 6(a) of that Statement consistent with this proposed SOP. The proposed amendments to APB Opinion 20 would reflect that retirement-replacement-betterment accounting would not be a preferred method of accounting for railroad track structures. The proposed amendments to APB Opinion 28 would have the effect of requiring consistent reporting of costs within the scope of this proposed SOP for interim and annual reporting periods.~~

~~AREAS REQUIRING PARTICULAR ATTENTION BY RESPONDENTS~~

~~Comments are specifically requested on the following issues addressed by this exposure draft.~~

~~Scope~~

~~*Issue 1*: Paragraph 10 of the proposed SOP states that the SOP does not provide specific guidance on lessor or lessee accounting for reimbursements of costs incurred by a lessor that are directly recoverable from lessees under the terms of one or more leases, and that the lessor and lessee should refer to FASB Statement No. 13, *Accounting for Leases*, and related lease accounting literature for guidance on accounting for such reimbursements. In many instances, depending on the terms of the lease, those reimbursements may constitute minimum lease payments or contingent rentals under FASB Statement No. 13. As discussed in paragraph A2 of the proposed SOP, AcSEC elected not to address the accounting for such transactions in this SOP because AcSEC did not want to create conflicts with existing lease accounting guidance and AcSEC did not believe it was appropriate to address the accounting under all of the various reimbursement scenarios and arrangement structures within the scope of this SOP. Are there significant practice issues or concerns related to the accounting for contractually recoverable expenditures that should be addressed in the proposed SOP? Do you believe that there are other areas addressed in the~~

~~proposed SOP that, with respect to their application to lessors and lessees of PP&E, could create conflicts with existing lease accounting standards?~~

~~Project Stage Framework~~

~~*Issue 2*: The guidance in this proposed SOP is presented in terms of a project stage or time line framework and on the basis of the kinds of activities performed during the stages defined in the proposed SOP rather than on whether an expenditure fits into certain classification categories such as ordinary repairs and maintenance, "extraordinary" repairs and maintenance, replacements, betterments, additions, redevelopments, renovations, rehabilitations, retrofits, rearrangements, refurbishments, and reinstallations. Do you agree with that approach? If not, what alternative would you propose and why?~~

~~*Issue 3*: Paragraph 16 of the proposed SOP states that the preliminary stage ends and the preacquisition stage begins when the acquisition of specific property, plant, and equipment (PP&E) is considered probable. Paragraph 22 of the proposed SOP states that, other than the costs of options to acquire PP&E, all costs incurred during the preliminary stage should be charged to expense as incurred. Do you agree with that conclusion? If not, how would you propose to modify the guidance and why?~~

~~Accounting for Costs Incurred~~

~~*Issue 4*: The proposed SOP states that PP&E-related costs incurred during the preacquisition, acquisition-or-construction, and in-service stages should be charged to expense unless the costs are directly identifiable with the specific PP&E. Directly identifiable costs include only (a) incremental direct costs incurred with independent third parties for the specific PP&E, (b) employee payroll and payroll benefit-related costs related to time spent on specified activities performed by the entity during those stages, (c) depreciation of machinery and equipment used directly in the construction or installation of PP&E and incremental costs directly associated with the utilization of that machinery and equipment during the acquisition-or-construction stage, and (d) inventory (including spare parts) used directly in the construction or installation of PP&E. All general and administrative and overhead costs incurred, including all costs of support functions, should be charged to expense. See paragraphs 24, 25, 29, and 30. Do you agree with those conclusions? If not, what alternatives would you propose and why?~~

~~*Issue 5*: Paragraph 32 of the proposed SOP states that for real estate that is not being used in operations, costs of property taxes, insurance, and ground rentals should be capitalized, to the extent of the portion of the property that is under development, during the time that activities that are necessary to get the asset ready for its intended use are in progress. Do you agree with that conclusion? If not, what alternative would you propose and why?~~

~~*Issue 6*: Paragraph 37 of the proposed SOP states that the costs of normal, recurring, or periodic repairs and maintenance activities should be charged to expense as incurred. It also states that all other costs related to PP&E that are incurred during the in-service stage should be charged to expense as incurred unless the costs are incurred for (a) the acquisition of additional PP&E or components or (b) the replacement of existing PP&E or components of PP&E. Do you agree with those conclusions? If not, what alternatives would you propose and why?~~

~~*Issue 7*: Paragraph 39 of the proposed SOP states that costs of removal, except for certain limited situation demolition costs, should be charged to expense as incurred. Do you agree with that conclusion? If not, what alternative would you propose and why?~~

~~*Issue 8*: Paragraph 44 of the proposed SOP states that the total of costs incurred for planned major maintenance activities does not represent a separate PP&E asset or component. It states that certain of those costs should be capitalized if they represent acquisitions or replacements and that all other costs should be charged to expense as incurred. Paragraph 45 prohibits alternative accounting treatments including (a) the accrual of a liability for the estimated costs of a planned major maintenance activity prior to their being incurred, and (b) the deferral and amortization of the entire cost of the activity. Do you agree with those conclusions? If not, what alternatives would you propose and why?~~

~~*Issue 9*: Paragraph 45 of the proposed SOP further prohibits, as an alternative accounting treatment, the "built-in overhaul" method for costs incurred for planned major maintenance activities. Under that method, additional depreciation expense is recognized currently to give effect to the decline in service potential that is subsequently restored once the major maintenance activity occurs. When the major maintenance activity occurs, its cost is considered capitalizable. In lieu of the built-in overhaul method, AcSEC concluded that better cost allocation would result from the use of component accounting and limiting the major maintenance activities that would be capitalizable to costs that represent replacements of components of PP&E. Should the costs of restoring PP&E's service potential, in addition to the cost of replacements that would be capitalizable under this proposed SOP, be eligible for capitalization? Do you believe that prohibiting the built-in overhaul method is appropriate, or should it be allowed as an alternative method? If you believe that the built-in overhaul method should continue to be allowed, what industries or entities should be allowed to use it, and why?~~

~~**Use of Inventory in Production of Internal-Use PP&E**~~

~~*Issue 10*: Paragraphs 47, 48, and A41 of the proposed SOP discuss the situation in which an entity owns an asset that it intended to sell as inventory but subsequently decided to retain for use in its own internal operations. Those paragraphs state that the entity should evaluate for impairment amounts included in PP&E that were previously capitalized as inventory but should not redetermine their carrying amount as PP&E using the guidance in the proposed SOP, unless the entity has a pattern of changing the intended use of assets from inventory to PP&E. Do you believe that guidance is appropriate, or should an entity be required to redetermine the carrying amount of PP&E assets previously capitalized as inventory, and why? Should AcSEC provide additional guidance on what kinds of changes in intended use constitute a "pattern," and why?~~

~~**PP&E-Type Assets Produced for Sale or Operating Lease**~~

~~*Issue 11*: The proposed SOP requires assets that are produced by an entity to be leased to a lessee under an operating lease to be accounted for under the provisions of this SOP. As discussed in paragraph A43 of the proposed SOP, AcSEC recognizes that some entities routinely construct or manufacture products, some of which are sold directly and some of which are leased to lessees under sales-type leases whereas others are leased to lessees under operating leases. In some situations, the entity does not know the form the transaction will take until it occurs, and the customer decides whether its acquisition of product will be accomplished through purchase or lease. The proposed SOP requires an entity to accumulate costs differently for similar assets depending on whether the asset is sold outright or leased to a lessee under a sales-type lease (in either case, inventory cost accumulation rules would apply) or leased to a lessee under an operating lease (in which case, the cost accumulation provisions of the proposed SOP would apply). Do you agree with that conclusion and, if so, do you believe the proposed SOP should provide additional guidance on such cost accumulation? Or would it be preferable for a single~~

~~cost accumulation model to apply during the production process and that there should be a presumption that the assets should be accounted for all as inventory or all as PP&E? If so, which presumption should be applied and why?~~

~~Component Accounting~~

~~*Issue 12*: Paragraphs 49 through 56 of the proposed SOP discuss component accounting and state that if a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the component should be accounted for separately and depreciated or amortized over its separate expected useful life. Do you agree with this approach to accounting for PP&E? If not, what alternative would you propose and why?~~

~~*Issue 13*: Paragraphs 38 and 51 of the proposed SOP state that when existing PP&E is replaced or otherwise removed from service and the replacement is capitalized, the net book value of the replaced PP&E should be charged to depreciation expense in the period of replacement. Do you agree with this approach? If not, what alternative would you propose and why?~~

~~*Issue 14*: The proposed SOP requires the use of component accounting to depreciate identified components over their respective expected useful lives. As noted in paragraph A48 of the proposed SOP, entities have developed and utilized various conventions to depreciate assets, including group depreciation or use of composite lives. Those conventions are acceptable only if they result in approximately the same gross PP&E, depreciation expense, accumulated depreciation, and gains or losses on disposals of PP&E as the component accounting method required by this proposed SOP. Do you agree with this approach? If not, what alternative would you propose and why?~~

~~Amendments to Other Guidance~~

~~*Issue 15*: Paragraphs 61 and 63 of the proposed SOP list amendments to SOP 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives*, and the AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives*, respectively. Do you agree with the proposed amendments? Do you believe that there are unique aspects of agricultural accounting, such as the accounting for breeding and production animals and the accounting for plants and vines, that should not be amended by the proposed SOP, and why?~~

~~Transition~~

~~*Issue 16*: Paragraph 71 of the proposed SOP states that the prescribed component accounting guidance should be initially adopted for existing PP&E using one of two alternatives, the election and disclosure of which should be made when the SOP is adopted. Do you agree with that approach and, if so, do you agree with the choice of the two alternatives from which the election is to be made? If you do not agree with that approach for existing PP&E, what approach would you propose and why?~~

~~*Issue 17*: Under paragraph 71(a) of the proposed SOP, the allocation of existing net book value to components at transition should be based on (a) allocation of original accounting records, if available, (b) relative fair values of components at date of transition, if original accounting records are not available, or (c) another reasonable method, if relative fair value is not practicable. Do you agree that that ordering of allocation methods is appropriate? If you believe that a different order would be appropriate, what order would you propose and why? Should the~~

~~proposed SOP provide additional examples to illustrate what constitutes "another reasonable method"?~~

~~*Issue 18*: Paragraph 72 of the proposed SOP states that the SOP should be applied prospectively for all costs incurred after the adoption of the SOP. It also states that costs incurred prior to the adoption of the proposed SOP should not be re-characterized (as capital or expense items) to conform to the guidance in the SOP, with the exception of certain costs of planned major maintenance activities. Do you agree with that approach? If you do not agree with that approach, what approach would you propose and why?~~

~~*Issue 19*: Under paragraph 71(a) of the proposed SOP, and as illustrated in Example 3 in appendix C, an entity applying component accounting retroactively at date of adoption may calculate a difference between the pre-adoption balance of accumulated depreciation and the balance recalculated based on the estimated useful lives of components that previously were not accounted for as separate components. Under that paragraph, the difference is allocated back to the accumulated depreciation of each component based on the net book values of the components. Two alternatives considered were recording the difference as a cumulative effect type adjustment at adoption and recording the difference as additional depreciation expense at adoption. Do you agree with the proposed approach or either of the alternatives, and why?~~

~~AcSEC welcomes comments or suggestions on any aspect of this exposure draft. When making comments, please include reference to specific paragraph numbers, including reasons for any comments or suggestions, and provide alternative wording where appropriate.~~

~~Comments on the exposure draft should be addressed to Marc Simon, Technical Manager, Accounting Standards, File 4210.CC, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775, in time to be received by October 15, 2001. Responses may also be sent by electronic mail to **msimon@aicpa.org**. Responses should not be faxed.~~

~~Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA offices after October 15, 2001, for one year.~~

~~Sincerely,~~

~~David B. Kaplan, CPA~~
~~*Chair*~~
~~*Accounting Standards Executive Committee*~~

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~~*Chair*~~
~~*PP&E Accounting Task Force*~~

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~~SUMMARY~~

~~This Statement of Position (SOP) provides guidance on accounting for certain costs and activities relating to property, plant, and equipment (PP&E). For purposes of this SOP, a project stage or timeline framework is used and PP&E assets are accounted for at a component level. Costs incurred for PP&E are classified into four stages: preliminary, preacquisition, acquisition-or-construction, and in-service. The SOP requires, among other things, the following:~~

- ~~Preliminary stage costs, except for payments to obtain an option to acquire PP&E, should be charged to expense as incurred.~~

- ~~Preacquisition and acquisition-or-construction stage costs should be charged to expense as incurred unless the costs are directly identifiable with the specific PP&E. Directly identifiable costs include only:~~

  1. ~~Incremental direct costs of activities incurred in transactions with independent third parties for the specific PP&E.~~
  2. ~~Certain costs directly related to specified activities performed by the entity for the specific PP&E.~~
  3. ~~Payments to obtain an option to acquire PP&E.~~

- ~~Costs related to PP&E that are incurred during the in-service stage, including costs of normal, recurring, or periodic repairs and maintenance activities, should be charged to expense as incurred unless the costs are incurred for (1) the acquisition of additional PP&E or components of PP&E or (2) the replacement of existing PP&E or components of PP&E.~~

- ~~Removal costs incurred during replacement of PP&E, except for certain demolition costs, should be charged to expense as incurred.~~

- ~~During all stages, general and administrative costs and overhead costs, including costs of support functions, should be charged to expense as incurred.~~

- ~~Costs of planned major maintenance activities are not a separate PP&E asset or component. Those costs should be charged to expense, except for acquisitions or replacements of components that are capitalizable under the in-service stage guidance of this SOP.~~

- ~~A component is a tangible part or portion of PP&E that (1) can be separately identified as an asset and depreciated or amortized over its own expected useful life and (2) is expected to provide economic benefit for more than one year. If a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the cost should be accounted for separately and depreciated or amortized over its expected useful life. Component accounting should begin at the~~

~~time of acquisition or construction. Component accounting for a replacement should begin at the time of replacement. If an entity replaces a part or portion of a PP&E asset that has not been previously accounted for as a separate component, and the replacement meets the definition of a component, then the entity should capitalize the replacement, account for it as a separate component going forward, estimate the net book value of the replaced item, and charge that net book value to depreciation expense in the period of replacement.~~

~~This SOP is effective for financial statements for fiscal years beginning after June 15, 2002, with earlier application encouraged.~~

~~TABLE OF CONTENTS~~Brian K. Drake
James L. Ross
Leonard J. Gatti Joseph R. Trpik, Jr.
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SUMMARY *[TO BE UPDATED AFTER APRIL-MAY 2002 AcSEC MEETING]*

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FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least ten of AcSEC's fifteen members, and (3) a final document that has been approved by at least ten of AcSEC's fifteen members. The document is cleared if at least five of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following.

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

~~PROPOSED~~ STATEMENT OF POSITION

ACCOUNTING FOR CERTAIN COSTS AND ACTIVITIES RELATED TO PROPERTY, PLANT, AND EQUIPMENT

BACKGROUND

1. This Statement of Position (SOP) addresses accounting and disclosure issues related to certain **property, plant, and equipment (PP&E)**[1] costs and activities. Those costs include expenditures related to PP&E, including those for initial acquisition, construction, improvements, replacements, betterments, additions, and repairs and maintenance (and terms similar to those such as redevelopments, refurbishments, renovations, rearrangements, **planned major maintenance activities**, turnaround costs, overhauls, retrofits, and rehabilitations).

2. Diversity in accounting for those kinds of costs ~~has~~had been widely observed. Some entities capitalized certain of those expenditures whereas others charged expenditures for similar items to expense as incurred. Also, some entities ~~group, or "batch," and capitalize~~grouped, or "batched," and capitalized certain expenditures that would ordinarily have been charged to expense as incurred.

3. A related issue is the accounting for indirect and overhead costs**,** and allocation of such costs to PP&E. Some entities analogized to the guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, in determining the accounting for indirect and overhead costs. FASB Statement No. 67 ~~allows~~allowed capitalization of certain overhead costs that ~~can be~~could have been allocated to specific PP&E, such as officer salaries based on timesheet inputs and rent expense based on square footage. Other entities analogized to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Under ~~the~~a FASB Statement No. 91 approach, only certain costs directly related to a project, and that would not have been incurred but for that project, ~~are~~would be capitalized. AICPA SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, incorporates the FASB Statement No. 91 approach and states that overhead costs should be excluded from capitalization. Those and other approaches ~~have~~had resulted in diverse accounting between entities with similar circumstances.

4. In some cases, costs of certain PP&E (for example, a building) ~~are~~were recorded in a single asset account and charged to expense through depreciation over an expected useful "composite" life, such as forty years. In practice, the composite life may not ~~be~~have been determined with a high degree of precision, and hence the composite life may not

[1] Words or terms defined in the glossary are in **boldface type** the first time they appear in this Statement of Position (SOP).

~~reflect~~have reflected the weighted average of the **expected useful lives** of the asset's principal **components**. In addition, the composite life may not have always been revised to take into account dispositions, retirements, or replacements of the asset's principal components.

5. Finally, some have observed that entities capitalize replacement components of an asset (for example, a new roof on a building) without ascertaining the remaining undepreciated book value of the replaced component (for example, the old roof that has been replaced) and removing that amount from the accounting records.

~~6. The original scope of this project was limited to certain costs associated with real estate that were outside the scope of FASB Statement No. 67. Pursuant to subsequent discussions with both the FASB and the Securities and Exchange Commission (SEC) staff, the project's scope was expanded to provide guidance for all PP&E, including the accounting methods used for planned major maintenance activities.~~6. [NOT USED]

7. Concurrent with the issuance of this SOP, the FASB is issuing a Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment*, that amends FASB Statement No. 67; FASB Statement No. 51, *Financial Reporting by Cable Television Companies*; Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*; and APB Opinion No. 28, *Interim Financial Reporting*. It also rescinds FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*. The amendments to FASB Statement No. 67 exclude from the scope of that Statement the accounting for acquisition, development, and construction costs of real estate developed by an entity for rental. The amendments to FASB Statement No. 51 make the accounting for certain plant and overhead costs in paragraph 6(a) of that Statement consistent with the SOP. The amendment to APB Opinion 20 and rescission of FASB Statement No. 73 reflect that retirement-replacement-betterment accounting is not a preferred method of accounting for railroad track structures. The amendments to APB Opinion 28 have the effect of requiring consistent reporting of costs within the scope of this SOP for interim and annual reporting periods.

SCOPE

8. This SOP applies to all nongovernmental entities, including not-for-profit organizations and regulated entities. These include development-stage entities and entities that report substantially all assets at fair value (such as companies that are within the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies*). This SOP applies to railroad track structures.

9. This SOP applies to PP&E owners (including lessors of assets that are subject to operating leases) and lessees. With the exception of the component accounting provisions of this SOP, this SOP does not apply to a lessee's measurement of the amount at which to record an asset leased under a capital lease. FASB Statement No. 13,

Accounting for Leases, provides guidance with respect to a lessee's initial measurement of an asset under a capital lease. The component accounting provisions of this SOP apply to amounts capitalized by all PP&E owners (including lessors of assets that are subject to operating leases) and lessees. This SOP does not apply to the lessor's accounting for assets that are subject to sales-type or direct financing leases.

10. This SOP does not provide specific guidance on lessor or lessee accounting for reimbursements of costs incurred by a lessor that are directly recoverable from lessees under the terms of one or more leases. FASB Statement No. 13 and related lease accounting literature provide guidance on accounting for such reimbursements.

11. This SOP does not apply to internal-use software costs covered by SOP 98-1. It does not address insurance proceeds received as a result of casualty losses, or other insured ~~damages.~~

damages. It does not apply to the costs of spare parts or construction supplies prior to their inclusion in the construction or installation of PP&E. If spare parts or construction supplies are used in the construction or installation of PP&E, this SOP applies to those costs. This SOP does not apply to the costs of inventory (which are covered under Chapter 4 of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*), except for inventory used in the construction or installation of PP&E (see paragraph 28(b)(3) of this SOP).

11A. This SOP does not apply to removal costs, including demolition costs, incurred in connection with an asset retirement obligation under FASB Statement No. 143, *Accounting for Asset Retirement Obligations.*

11B. This SOP does not address the accounting for derivatives transactions that occur in connection with PP&E asset transactions. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides guidance on accounting for such derivatives transactions.

12. As discussed in paragraph 7 of this SOP, concurrent with issuance of this SOP, the FASB is changing APB Opinion 28, which will make the provisions of this SOP applicable to interim as well as annual reporting periods.

13. ~~APB Opinion No. 16, *Business Combinations,*~~[2]FASB Statement No. 141, *Business Combinations,* provides accounting guidance for the acquisition of a business and the allocation of purchase price to PP&E acquired as part of that business combination. That guidance is not changed. Applying component accounting to the purchase price allocated to PP&E under ~~APB Opinion 16~~FASB Statement No. 141 is covered by this SOP.

[2] ~~In June 2001, the Financial Accounting Standards Board (FASB) approved the issuance of FASB Statement No. 141, *Business Combinations*, which supersedes Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*. FASB Statement No. 141 is effective for business combinations initiated after June 30, 2001.~~

14. The following authoritative literature is not affected by the provisions of this SOP, but was considered by AcSEC in its deliberations: (a) FASB Statement No. 2, *Accounting for Research and Development Costs*; (b) FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, and the related AICPA Audit and Accounting Guide *Audits of Entities With Oil and Gas Producing Activities*; (c) FASB Statement No. 34, *Capitalization of Interest Cost*; and (d) the AICPA Audit and Accounting Guide *Construction Contractors*.

CONCLUSIONS

Project Stage Framework

15. AcSEC concluded that a project stage or timeline framework would best facilitate presentation and understanding of the relevant concepts in this SOP. Costs incurred for PP&E are classified into four stages: *preliminary*, *preacquisition*, *acquisition-or-construction*, and *in-service*. Appendix B provides a matrix to facilitate the understanding of that framework. For simple transactions, such as the purchase of a vehicle, substantially all of the costs related to the purchase may occur in the acquisition-or-construction stage.

16. The first two stages, the preliminary stage and the preacquisition stage, both occur prior to the acquisition of specific PP&E. The preliminary stage ends and the preacquisition stage begins when the acquisition or construction of specific PP&E is considered probable.[3] In assessing probability, the entity should consider whether (a) its management, having the relevant authority, has implicitly or explicitly authorized and committed to funding the acquisition or construction of a specific PP&E asset, (b) the financial resources are available consistent with such authorization, and (c) the ability exists to meet the requisite local and other governmental regulations.

17. During the preliminary stage, an entity's activities include exploration of various opportunities for acquisition or construction of PP&E. An entity may conduct feasibility studies and other activities related to asset selection. The entity may incur costs to obtain an option to acquire one or more items of PP&E during this stage. Examples of other costs that may be incurred include surveying, zoning, engineering studies, design layouts, traffic studies, and costs associated with obtaining management's approval to move forward with particular PP&E acquisition or construction.

[3] *Probable* is defined in FASB Statement No. 5, *Accounting for Contingencies*, as "likely to occur" and is used in the same sense in this SOP.

18. During the preacquisition stage, certain of an entity's activities and kinds of costs incurred may be similar to those activities and costs incurred during the preliminary stage except that in the preacquisition stage they occur after it is probable that the entity will acquire specific ~~PP&E.~~
PP&E. In determining what constitutes "specific PP&E" for purposes of assessing probability, an entity may need to assess distinct costs of a PP&E project separately. For example, if an entity incurs costs to prepare architectural drawings and it is probable that an entity will build the building according to the design specified in those drawings, but the entity has not yet selected a land site, then the costs of the drawings would be subject to the preacquisition stage guidance in this SOP. However, if an entity incurs architectural costs for several different designs for a building, the construction of which is probable, at most one of the designs could be considered probable, and the costs of the designs not considered probable would be subject to the preliminary stage guidance in this SOP.

19. The third stage, the acquisition-or-construction stage, begins at the time the entity obtains ownership of the PP&E or obtains the right to use the PP&E through an agreement (for example, a lease). During this stage, acquisition, construction, or installation activities related to the PP&E occur. Examples of those activities include planning for construction or installation once ownership, or the right to use, has been acquired; constructing or installing PP&E; and supervising the construction or acquisition of PP&E.

20. The fourth and final stage, the in-service stage, commences when the PP&E is **substantially complete and ready for its intended use**.[4] Costs incurred during this stage relate principally to replacements and repairs and maintenance but may also include relocation costs.

21. A PP&E asset is often comprised of multiple components, which may have expected useful lives different from the life assigned to the PP&E asset. This SOP addresses the accounting for those components.

Accounting for Costs Incurred

Preliminary stage

22. Payments to obtain an option[5] to acquire PP&E should be capitalized. Subsequent to initial recognition, the option should be carried at the lower of cost or fair value less cost to sell. Reductions in the recorded value of an option should be charged to expense. Amounts charged to expense should not be reinstated to the balance sheet if the option's

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[4] ~~The phrase *substantially complete and ready for its intended use* is used here with the same meaning that it has related to interest capitalization in paragraph 18 of FASB Statement No. 34, *Capitalization of Interest Cost*.~~

[5] If the option meets the definition of a derivative instrument within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, it should be accounted for in accordance with that Statement.

fair value less cost to sell subsequently increases. All other internal and external costs related to PP&E that are incurred during the preliminary stage should be charged to expense as incurred.

Preacquisition stage

23. ~~All costs~~Costs related to PP&E that are incurred during the preacquisition stage should be charged to expense as incurred unless the costs are directly identifiable with the specific PP&E. ~~Directly~~Subject to the provisions of paragraphs 24 and 25 of this SOP, directly identifiable costs include only:

a. **Incremental direct costs** of PP&E preacquisition activities incurred for the specific PP&E in transactions with **independent third parties**.

b. Certain costs directly related to preacquisition activities performed by the entity (or by third parties who are not independent of the entity) for the specific PP&E. Those costs include only payroll and payroll benefit-related costs (for example, costs of health insurance) of employees who devote time to a PP&E preacquisition stage activity, to the extent of time the employees spent directly on that activity and in proportion to the total hours employed (including compensated absences). ~~Rent, depreciation, and other occupancy~~Occupancy costs, including rent and depreciation of facilities and other costs associated with ~~the physical space~~facilities occupied by employees are excluded from directly identifiable costs and should be charged to expense as incurred.

c. Payments to obtain an option[6] to acquire PP&E. The option should be carried at the lower of cost or fair value less cost to sell. Reductions in the recorded value of an option should be charged to expense. Amounts charged to expense may not be reinstated to the balance sheet if the fair value less cost to sell of the option subsequently increases.

24. General and administrative costs and overhead costs incurred by the entity should be charged to expense as incurred. Those costs include~~rent, depreciation, and other~~ occupancy costs ~~associated with the physical space occupied by employees,~~as described in paragraph 23(b) of this SOP and all costs (including payroll and payroll benefit-related costs) of support functions, which include executive management, corporate accounting, acquisitions, purchasing, corporate legal, office management and administration, marketing, human resources, and information systems.

25. General and administrative costs and overhead costs should be charged to expense as incurred whether incurred internally by the entity or by another enterprise on behalf of the entity. For example, an entity that outsources its acquisitions or purchasing department to a third party should charge the costs to expense as incurred because an acquisitions or purchasing department represents a support function and the entity could choose to establish its own internal acquisitions or purchasing department.

[6] See footnote ~~5.~~3.

26. Incremental direct costs incurred in transactions with an independent third ~~party, which~~party that are capitalizable under paragraph 23(a) of this SOP~~,~~ often include an element of the third party's administrative overhead. That element is considered to be an incremental direct cost in accordance with that paragraph and accordingly should be capitalized.

27. Capitalized preacquisition stage costs should be included in the cost of the specific PP&E upon its acquisition. If it becomes no longer probable that the specific PP&E will be acquired, the preacquisition stage costs previously capitalized related to the specific PP&E should be reduced to the lower of cost or fair value less cost to sell. A rebuttable presumption exists that the fair value of those preacquisition stage costs (excluding option costs) is zero (that is, the costs of the asset would be charged to expense), unless management, having the authority to approve the action, has committed to a plan to sell the asset and the proceeds can be reasonably estimated. If an entity subsequently acquires PP&E previously considered no longer probable to acquire, preacquisition-stage costs charged to expense under this paragraph should not be subsequently reversed.

Acquisition-or-construction stage

28. Costs related to PP&E that are incurred during ~~this~~the acquisition-or-construction stage should be ~~capitalized if~~charged to expense as incurred unless the costs are directly identifiable with the specific PP&E or the costs meet the requirements in paragraphs 32 through 35. Subject to the provisions of paragraphs 29 and 30 of this SOP, directly identifiable costs include only:

a. Incremental direct costs of acquiring, constructing, or installing the PP&E incurred in transactions with independent third parties for the specific PP&E.

b. Certain costs directly related to specified activities performed by the entity (or by third parties who are not independent of the entity) for the acquisition, construction, or installation of the specific PP&E, and costs directly related to preproduction test runs of PP&E that are necessary to get the PP&E ready for its intended use.[7] Those costs include only (1) payroll and payroll benefit-related costs of employees who devote time to a PP&E acquisition-or-construction stage activity, to the extent of time the employee spent directly on that activity and in proportion to the total hours employed (including compensated absences), (2) depreciation of machinery and equipment used directly in the construction or installation of PP&E, to the extent of time the machinery and equipment is used directly in that activity as a percentage of

[7] In the context of preproduction test runs, PP&E is considered ready for its intended use when it is first capable of producing a unit of product that is either saleable or usable internally by the entity. Costs subsequently incurred by the entity to enhance the production efficiency of the PP&E—for example, to increase a machine's hourly output—should be charged to expense as incurred. Costs incurred to change PP&E from one intended use to another—for example, to change paper-producing equipment from producing letter-size to legal-size paper—should be accounted for in accordance with the in-service stage guidance in paragraph 37 of this SOP.

its expected useful life, and incremental costs (such as fuel for machinery) directly associated with the utilization of that machinery and equipment, and (3) the cost of inventory~~(including spare parts)~~ used directly in the construction or installation of PP&E. ~~Rent, depreciation, and other occupancy~~Occupancy costs, including rent and depreciation of facilities and other costs associated with ~~the physical space~~facilities occupied by employees are excluded from directly identifiable costs and should be charged to expense as incurred.

29. General and administrative costs and overhead costs incurred by the entity should be charged to expense as incurred. Those costs include~~rent, depreciation, and other~~ occupancy costs ~~associated with the physical space occupied by employees,~~as described in paragraph 28(b) of this SOP and all costs (including payroll and payroll benefit-related costs) of support functions, which include executive management, corporate accounting, acquisitions, purchasing, corporate legal, office management and administration, marketing, human resources, and information systems.

30. General and administrative costs and overhead costs should be charged to expense as incurred whether incurred internally by the entity or incurred by another enterprise on behalf of the entity. For example, an entity that outsources its information systems department to a third party should charge the costs to expense as incurred, because information systems represents a support function and the entity could choose to establish its own internal information systems department.

31. Incremental direct costs incurred in transactions with an independent third party, which are capitalizable under paragraph 28(a) of this SOP, often include an element of the third party's administrative overhead. That element is considered to be an incremental direct cost in accordance with that paragraph and accordingly should be capitalized.

32. In the case of real estate, costs incurred for property taxes, insurance, and **ground rentals** should be capitalized, for the portion of the property under construction, during the time that activities that are necessary to get the asset ready for its intended use are in progress.[8] For example, if an entity has a fifty-acre tract of land and is constructing a building on a five-acre plot of that land, capitalization would be limited to the portion of those costs attributable to the five-acre plot. If a property under construction remains in operation while the construction takes place, costs incurred for property taxes, insurance, and ground rentals should be capitalized only if they are incremental and directly attributable to the construction activities. Capitalization of costs incurred for property taxes, insurance, and ground rentals should cease if the building or structure is substantially complete and ready for its intended ~~use but no later than the date initial operations~~use. A building or structure held for lease whose ~~commence in any portion of the building or structure.~~

[8] The phrase *activities that are necessary to get the asset ready for its intended use are in progress* is used here with the same meaning that it has related to interest capitalization in paragraph 17 of FASB Statement No. 34.

~~33. **Demolition costs** incurred by an owner or lessor should be charged to expense as incurred and included in results of operations, except when incurred in conjunction with an acquisition or lease of real estate and the demolition (a) is contemplated as part of the acquisition or at lease inception and (b) occurs within a reasonable period of time thereafter or is delayed, but the delay is beyond the entity's control (for example, if demolition cannot commence until the end of an existing tenant's lease term or demolition is subject to governmental permitting processes).[9] Demolition costs meeting the above conditions should be capitalized as part of the cost of the real estate; whether the demolition costs are capitalized as land or building depends on the nature of the costs. For example, costs related to the demolition of a building in preparation for new construction would be capitalized as part of the land, whereas costs related to gutting the interior of a warehouse in preparation for reconstructing the interior as office space would be capitalized as part of the building.~~

shell is substantially complete, but for which leasehold improvements have not yet been constructed, is considered substantially complete and ready for its intended use.

~~34.~~33. When PP&E is substantially complete and ready for its intended use, all expenses associated with the PP&E should be recognized in operations as they accrue, including carrying costs (such as property taxes, insurance, and ground rentals).

~~rentals), and depreciation should begin. PP&E should be considered substantially complete and ready for its intended use upon completion of all major construction and installation activities (as distinguished from activities such as routine maintenance and cleanup) or when related revenues begin to be recognized, if sooner.~~

~~35.~~34. If a portion of a PP&E project is substantially complete and ready for its intended use and is capable of being operated independently from other portions of the PP&E project that are not yet substantially complete, the substantially complete portion should be accounted for as a separate project.~~[10]~~ Costs incurred that are not specific to a particular project should be allocated between or among those separate projects to which they relate. Allocation should be based on the relative fair value of each project. If allocation based on fair value is not practicable, allocation should be based on another reasonable, appropriate method, such as relative square footage for real estate.

35. **Demolition costs** incurred by an owner or lessee should be charged to expense as incurred and included in results of operations, except when incurred in conjunction with

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~~[9] In June 2001, the FASB approved the issuance of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. FASB Statement No. 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002.~~

~~[10] For purposes of applying this paragraph, the portions of a building or structure are considered collectively rather than as separate projects for purposes of determining when capitalization of costs incurred for property taxes, ground rentals, and insurance should cease. See paragraph 32 of this SOP.~~

an acquisition or lease of real estate and the demolition (a) is probable at the time of the acquisition or at lease inception and (b) occurs within a reasonable period of time thereafter or is delayed, but the delay is beyond the entity's control (for example, if demolition cannot commence until the end of an existing tenant's lease term or demolition is subject to governmental permitting processes). Demolition costs meeting both (a) and (b) should be accounted for under paragraphs 28 through 31 of this SOP. Demolition costs capitalized under those paragraphs should be capitalized as part of the cost of the real estate; whether the demolition costs are capitalized as land or building depends on the nature of the costs. For example, costs related to the demolition of a building in preparation for new construction would be capitalized as part of the land, whereas costs related to gutting the interior of a warehouse in preparation for reconstructing the interior as office space would be capitalized as part of the building.

In-service stage

36. The in-service stage begins once a PP&E asset or component is substantially complete and ready for its intended use. During this stage, an entity may incur costs that may be referred to in terms similar to those listed in paragraph 1 of this SOP. All those costs may be categorized as (a) repairs and maintenance of existing components, (b) replacement of existing components, or (c) acquisition of additional components.

~~37. The~~37. The costs of normal, recurring, or periodic repairs and maintenance activities and all other costs related to PP&E that are incurred during the in-service stage should be charged to expense as incurred unless the costs are incurred for (a) the acquisition of additional components of PP&E or (b) the replacement of existing components of PP&E. This does not preclude the capitalization, in accordance with paragraphs 28 through 31 of this SOP, of certain costs incurred early in the in-service stage that are necessary for the completion of the project (for example, punch list items). Costs of replacing PP&E~~, with the exception of **removal costs**,~~ represent the acquisition of a new component of PP&E and should be accounted for in accordance with paragraphs 22 through 35 of this SOP.

37A. This paragraph applies to **removal costs** that are not considered to be demolition costs, the accounting for which is provided in paragraph 35 of this SOP. Removal costs that are incurred in conjunction with a replacement of PP&E or a component of PP&E should be accounted for under paragraphs 28 through 31 of ~~as discussed in paragraph 39.~~this SOP. Removal costs capitalized under those paragraphs should be recorded as a cost of the replacement. Removal costs that are not incurred in conjunction with a replacement should be charged to expense as incurred. Costs incurred to relocate existing PP&E or a component of PP&E should be ~~expensed as incurred.[11]~~
charged to expense as incurred.[12]

~~[11] Relocation costs include directly identifiable costs of dismantlement, crating, shipping, and reinstallation of PP&E or a component of PP&E that has been in service.~~

[12] Relocation costs include directly identifiable costs of dismantlement, crating, shipping, and reinstallation of PP&E or a component of PP&E that has been in service.

38. In conjunction with a replacement, if existing PP&E or a component of PP&E is removed from service, the remaining net book value of that PP&E or component (or a reasonable estimate, as described in paragraph 53 of this SOP, if the net book value is not separately determinable from the accounting records) should be charged to depreciation expense in the period of replacement. If existing PP&E is involved in an exchange transaction that is subject to APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, the provisions of that Opinion should apply; PP&E acquired through such an exchange transaction is subject to the provisions of this SOP.

39. ~~Costs of removal, except for certain demolition costs discussed in paragraph 33, including costs necessary to disassemble a component to gain access to a subcomponent to be replaced, should be charged to expense as incurred.~~[NOT USED]

40. Concurrent with replacement of a component, an entity should consider the need to reevaluate the associated lives of the components of the remaining PP&E asset. Any change in the associated lives of the components of that remaining asset should be accounted for as a change in accounting estimate in accordance with paragraph 11 of APB Opinion 20.

41. Subject to the limitations discussed in paragraphs 29 and 30 of this SOP, incremental direct costs required by a contractual agreement for the sale of PP&E that obligates the entity to incur costs to effect the ultimate sale should be capitalized, subject to the requirements of FASB Statement No. ~~121,~~144, *Accounting for the Impairment or Disposal of Long-Lived* ~~*Assets and for Long-Lived Assets to Be Disposed Of.*~~[13] *Assets.*

Planned major maintenance activities

42. Entities often incur costs for planned major maintenance activities that are required to keep PP&E properly maintained or running efficiently. Certain of those activities may be required by law (for example, required maintenance for specific aircraft components).

43. Costs incurred for planned major maintenance activities often include labor costs for repair and maintenance activities such as cleaning, servicing, replacement, or repair, as well as costs of replacement components, minor parts, and interactive agents (such as certain fluids or elements).

44. The total of costs incurred for planned major maintenance activities does not represent a separate PP&E asset or component. The individual costs incurred in such planned major maintenance activities should be evaluated to determine if they represent (a) the acquisition of additional components or (b) the replacement of existing components, and should be accounted for as discussed in paragraph 37 of this SOP. All

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~~[13] The FASB has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that would supersede FASB Statement No. 121. Readers should be alert to any final pronouncement.~~

other costs incurred in a planned major maintenance activity should be charged to expense as incurred.

45. The following accounting methods for planned major maintenance activities are not permitted:

a. Accrual of a liability, prior to actual costs being incurred, for the estimated costs of a planned major maintenance activity

b. Deferral and amortization of the entire cost of a planned major maintenance activity

c. Current recognition of additional depreciation or amortization to cover the future costs of a planned major maintenance activity (the "built-in overhaul" method)

Entities Reporting Substantially All Assets at Fair Value

46. Entities that report substantially all assets at fair value, with changes in fair value recognized in earnings, should nevertheless apply the provisions of this SOP and determine the appropriate treatment (capitalize or charge to expense) of PP&E costs incurred. The adjustment of assets to fair value should then be applied, with the resulting fair value adjustment to PP&E being recorded as a change in unrealized appreciation or depreciation in the statement of operations.

~~Use of Inventory in Production of Internal-Use PP&E~~Inventory and Leasing Considerations for PP&E-Type Assets

47. An entity may ~~produce~~acquire or construct an asset that the entity intends to be for sale in the ordinary course of business. That asset would be classified as inventory and the costs of the asset would be accumulated in accordance with the applicable accounting literature for inventory (for example, FASB Statement No. 67, as ~~inventory.~~amended by FASB Statement No. 144, in the case of real estate constructed for sale). If the entity subsequently~~determines that it will~~ retains the asset and utilizes it in its own internal operations or as an element in the construction of PP&E, the carrying amount of the asset should be evaluated for impairment under FASB Statement No. ~~121~~144 and the provisions of this SOP should be applied prospectively. Except as discussed in paragraph 48 below, a pattern of changing the intended use of significant amounts of assets from inventory to PP&E during the acquisition-or-construction or in-service stages creates a rebuttable presumption that any such assets subsequently produced by the entity are intended to be held and used as PP&E (and, therefore, should be accounted for in accordance with this SOP).

48. Nothing in the preceding paragraph should be read to require the application of this presumption to fungible units of inventory produced in large quantities, in which a small portion of the units produced are utilized as productive assets. For example, if a

computer manufacturer historically retains a small percentage of its computers for use by its internal staff, this does not create the presumption that the manufacturer should apply this SOP in capitalizing costs related to the manufacture of computers.

48A. An entity may originally classify an asset as inventory with the intention of selling it or leasing it to a lessee under a sales-type lease, but subsequently leases the asset to a lessee under an operating lease. An entity may acquire or construct assets in a situation where some are sold directly, some are leased to lessees under sales-type leases, and some are leased to lessees under operating leases, and the entity may not know what form the transaction will take until it occurs and until the customer decides whether it will purchase or lease. In each of those situations, an entity should accumulate costs differently for such assets based on whether the asset is sold outright or leased to a lessee under a sales-type lease (in either case, inventory cost accumulation requirements would apply) or leased to a lessee under an operating lease (in which case the cost accumulation provisions of this SOP should apply), as follows. To perform the cost accumulation, the entity should first estimate the total costs, under the assumption that all assets are to be sold outright, that would be allocable to inventory but would not be allocable to PP&E under this SOP (for example, occupancy costs). The entity should then allocate to inventory a percentage of those kinds of costs, when incurred, based on the estimated percentage of assets to be sold outright or leased to lessees under sales-type-leases (determined as a percentage of the total assets to be sold, leased under sales-type leases, and leased under operating leases). The remainder of those kinds of costs should be charged to expense as incurred. If the actual percentage of assets sold or leased under a sales-type lease differs significantly from the estimated percentage, the entity should adjust cost of sales and expense (for example, occupancy costs capitalized under inventory accounting but charged to expense as incurred under this SOP).

Component Accounting

49. A component is a tangible part or portion of PP&E that (a) can be separately identified as an asset and depreciated or amortized over its own separate expected useful life and (b) is expected to provide economic benefit for more than one year. If a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the cost should be accounted for separately and depreciated or amortized over its separate expected useful life. An entity should establish a component accounting policy and apply it consistently.

50. An entity should exercise reasonable judgement in determining its level of component accounting. Component accounting does not require the capitalization of PP&E, components of PP&E, or parts of a component that fall below certain reasonable thresholds or represent the normal, recurring, and periodic replacement of minor items. Costs related to such PP&E, components, or parts of a component should be charged to expense as incurred. Factors that an entity should consider in developing its level of component accounting include the number of similar PP&E assets, past and expected replacements, and past and expected repairs and maintenance expense. At a minimum, however, an entity should apply component accounting to a level such that significant

PP&E with varying expected useful lives would not be included in the same component. As an example of component accounting, an airline could consider each airframe and engine as separate components, and it might further consider each airframe as being comprised of three components: interiors, in-flight entertainment equipment, and airframe shell.

~~50.~~51. Component identification should occur at the time of acquisition or construction. Component accounting for a replacement should occur at the time of replacement. The costs assigned to components should be based on specific identification. If specific identification is not practicable, capitalized costs should be allocated to individual components based on relative fair value when the asset is placed in service. If allocation based on relative fair value is not practicable, capitalized costs should be allocated based on another reasonable method, such as relative square footage for real estate, as appropriate under the circumstances.

~~51.~~52. If an entity replaces a part or portion of a PP&E asset that previously has not been accounted for as a separate component,~~and~~ the replacement ~~meets the definition of~~should be expensed. If, however, the entity determines that the replacement should have been considered to be a component, then the entity should capitalize the cost of the replacement, account for it as a separate component going forward, estimate the net book value of the replaced item in accordance with paragraph 53, and charge the net book value of the replaced item to depreciation expense in the period of replacement. A consequence, therefore, of not previously applying component accounting to an adequate level is that the net book value of the replaced item is charged to depreciation expense in the period of the replacement, with net book value calculated using the expected useful life of the total PP&E asset to which the component relates. That would typically result in a charge in the year of replacement greater than if the replaced item had initially been accounted for using component accounting, because the expected useful life used for this calculation (life of the total PP&E asset) would typically be longer than that of the expected useful life of the replaced ~~component.~~item. See Example 2 in appendix C for an illustration.

~~52. Nothing in paragraphs 49 through 51 should be read to require the capitalization of certain PP&E or components of PP&E that fall below certain reasonable thresholds or represent the normal, recurring, and periodic replacement of minor items. Costs related to such PP&E, components, or items should be charged to expense as incurred. Entities should exercise reasonable judgment in applying this guidance.~~53. Concurrent with replacement of an item not previously considered to be a separate component, but considered going forward to be a separate component, an entity should reevaluate the level of component accounting and associated lives of the like components of the remaining PP&E asset and similar assets. Any change in the component accounting and associated lives of the components of that remaining asset and similar assets should be accounted for prospectively as a change in accounting estimate in accordance with paragraph 11 of APB Opinion 20. A pattern of capitalizing replaced items as described in paragraph 52 above, rather than charging them to expense as incurred, is an indicator that the entity's level of component accounting should be adjusted for similar assets.

~~53. If~~54. If not separately identifiable in the accounting records, the estimated net book value of an item to be replaced should be calculated by estimating the previously capitalized costs of the replaced PP&E component and subtracting an estimate of accumulated depreciation. The estimate of accumulated depreciation is calculated using the same depreciation method and expected useful life previously used to depreciate the total PP&E asset to which the component relates. See Examples 1 through 3 in appendix C for illustrations.

54A. An entity should reassess on an ongoing basis the estimated useful lives of its PP&E. When identified, a change in estimated useful~~54. Concurrent with replacement of an item not previously considered to be a separate component, an entity should reevaluate the level of component accounting and associated lives of the components of the remaining PP&E asset and similar assets. Any change in the component accounting and associated lives of the components of that remaining asset and similar assets~~life should be accounted for prospectively as a change in accounting estimate~~ in accordance with paragraph 11 of APB Opinion 20~~.

~~55. In addition, an entity should reassess on an ongoing basis the estimated useful lives of its PP&E. When identified, changes in estimated useful lives should be accounted for prospectively as changes in accounting estimate.~~

~~56.~~55. The component accounting provisions of this SOP apply to amounts capitalized by a lessor or lessee. However, the component accounting provisions do not modify the application of the lease classification criterion of paragraph 7(c) of FASB Statement No. 13, which is applied to the leased asset in its entirety.

56. Although a detailed discussion of depreciation is outside the scope of this SOP, the group-life method of accounting is considered an acceptable alternative to component accounting for certain PP&E if component accounting is not practicable for that PP&E and provided that all of the following criteria are met for that PP&E:

a) The method is applied to a large number of PP&E assets **homogeneous** as to physical characteristics, use, expected useful life, and dispersion of useful lives around the average. Examples include telephone poles, railroad cross ties, and the pipe sections in a natural gas pipeline.
b) The method is applied consistently from period to period.
c) The entity applying the group-life method has reasonable statistical data to support the parameters of the method, such as expected useful life and the dispersion of useful lives around the average. The method is further supported by regular, periodic statistical and historical studies.
d) The entity periodically assesses the expected useful life and related depreciation calculations, with adjustments made as appropriate.
e) In applying the group-life method, an entity monitors activity of the PP&E assets for any unusual, material early retirements, which constitute significant variations from retirements predicted by statistical and historical studies used in developing the

parameters of the method. An entity should record a current charge to earnings for those retirements under the method.

56A. In the application of the group-life method, if an asset in the group is retired normally—that is, in a manner other than as described in paragraph 56(e) above—whether or not the asset is replaced, its original gross book value and accumulated depreciation are removed from the PP&E asset accounts. An entity should charge to expense as incurred any replacement of a part or portion of an asset accounted for under the group-life method of accounting. That is, the capitalization scenario in paragraph 52 of this SOP is not applicable to such a part or portion. See appendix E of this SOP for a general discussion of the group-life method.

Liquidated Damages

57. A purchaser of PP&E should account for the receipt of contractually specified **liquidated damages** recoverable from the seller as a reduction of the PP&E cost. Any~~such~~ damages in excess of the total PP&E cost should be recognized by the purchaser as income.

Presentation and Disclosures

58. In addition to other PP&E presentation and disclosures requirements under generally accepted accounting principles, such as those in APB Opinion No. 12, *Omnibus Opinion—1967*, the carrying amounts of the following categories of PP&E should be ~~included~~presented either in the basic financial statements or disclosed in the notes to financial statements if the category is significant in relation to PP&E as a whole:

a. Land and land improvements
b. Buildings and building improvements
c. Machinery and equipment
d. Construction in progress

Capitalized preliminary stage costs (that is, options) and preacquisition stage costs should be included in construction in progress, until such time as the related PP&E asset is substantially complete and ready for its intended use.

59. Each of the above categories should be further subcategorized and included in the basic financial statements, or disclosed in the notes to financial statements, if costs within a category are ~~significant in relation to that category and have expected useful lives significantly different from that of the category~~significant, either quantitatively or qualitatively, in relation to PP&E as a whole. For example, an entity ~~should~~could subcategorize the "buildings and building improvements" category into subcategories, such as (a) tenant improvements (leasehold improvements) (b) integral equipment, such as heating, ventilation, and air conditioning (HVAC) and elevators, and (c) the building "shell." As another example, an entity ~~should~~could subcategorize its short-lived technology equipment within the "machinery and equipment" category ~~if the costs of that~~

~~technology equipment are significant in relation to the category as a whole~~. For each category or subcategory, the range of useful lives and the weighted average remaining useful life should be disclosed.

60. An entity should disclose the nature and total amount of the costs it characterizes as repairs and maintenance expense for each period for which an income statement is presented. Further, the entity should disclose any changes from previous reporting periods in the kinds or nature of costs included in repairs and maintenance expense.

AMENDMENTS TO OTHER GUIDANCE

61. This SOP amends SOP 85-3, *Accounting by Agricultural Producers and Agricultural Cooperatives*. Paragraphs 59, 60, and 61 of SOP 85-3 are deleted and replaced with the following:

> Costs of land, land improvements, orchards, groves, vineyards, intermediate-life plants, and productive animals are to be accounted for in accordance with the guidance in SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*.

61A. This SOP amends SOP 98-5, *Reporting on the Costs of Start-Up Activities*. The third bullet point in Illustration 3 of the Appendix of SOP 98-5 is replaced with the following:

- Security and utilities

62. This SOP amends the AICPA Industry Audit Guide *Audits of Airlines* as follows:

The title of the section immediately preceding paragraph 3.63 is changed to "Airframe and Engine Overhauls." The last sentence of paragraph 3.65 and paragraphs 3.67 and 3.68 in their entirety are deleted. Paragraphs 3.69 through 3.73 are deleted and replaced with the following:

> Overhaul expenditures are to be accounted for in accordance with the guidance for planned major maintenance activities in paragraphs 42 through 45 of SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*.

Paragraphs 3.74 and 3.75 are deleted and replaced with the following:

> Amounts capitalized or charged to expense for overhauls should be evaluated for conformity with the guidance for planned major maintenance activities in SOP 02-X. Time between overhauls (TBO) should be tested by reference to FAA overhaul requirements, manufacturers' specifications, or the carrier's experience.

Paragraph 3.77 is replaced with the following:

Costs of modification should be accounted for in accordance with the guidance in SOP 02-X.

The first two sentences of paragraph 3.96 are deleted and replaced with the following:

Property and equipment costs should be recorded by the air carrier in accordance with the guidance in SOP 02-X.

The second and third sentences under the "Property and equipment" heading in footnote 1 of paragraph 5.06 are ~~changed to:~~replaced with the following:

Expenditures related to repairs and maintenance, additions, replacements, and major overhauls are accounted for in accordance with SOP 02-X. ~~The level of component accounting of PP&E is such that the costs of major overhauls are charged to operating expenses as incurred.~~

63. This SOP amends the AICPA Audit and Accounting Guide *Audits of Agricultural Producers and Agricultural Cooperatives* as follows:

In paragraph 3.15, the third, fourth, and fifth sentences are deleted, and the second sentence is replaced with the following:

When this occurs, the costs of material, labor, machinery and equipment, and the related overhead applicable to such assets should be accounted for in accordance with the guidance in SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*.

In paragraph 6.25, the third sentence is replaced with the following:

Cultural costs during the development period, including stakes and wires, grafting, and labor for pruning and forming, should be accounted for in accordance with the guidance in SOP 02-X.

In paragraph 6.27, the third sentence is replaced with the following:

However, the capitalized cost of trees and vines lost through abnormal events, such as unusual disease, frost, or flood, should be written off in the year of loss and the costs to replant should be accounted for in accordance with the guidance in SOP 02-X.

In paragraph 6.34, the last sentence is replaced with the following:

Accumulated costs for these plants and vines, whether acquired on a contract basis or self-developed, should be accounted for in accordance with the guidance in SOP 02-X.

In paragraph 6.35, the last sentence is replaced with the following:

> The capitalized costs should be classified with property, plant, and equipment; financial statement disclosure of the costs and estimated useful lives should be made in accordance with the guidance in SOP 02-X.

In paragraph 6.47, the first sentence is replaced with the following:

> Whether breeding animals are of registered or commercial grade, their primary purpose is generally to produce young animals for sale.

In paragraph 6.50, the first bullet point is replaced with the following:

> Transfer to the breeding herd, in which case the costs would be accumulated in accordance with SOP 02-X. After the animal is mature and the breeding process is begun, the costs become part of the depreciable cost of the breeding herd.

The second sentence of paragraph 6.55 is deleted.

The following sentence is added at the end of paragraph 6.57:

> If the costs of flocks are classified as fixed assets, the costs should be accounted for in accordance with the guidance in SOP 02-X.

Paragraph 6.74 is replaced with the following:

> Land development costs other than those of a recurring nature represent additions to fixed assets that should be accounted for in accordance with the guidance in SOP 02-X. Permanent land development costs should not be subject to depreciation or amortization because they have an indefinite useful life. Limited life development costs should be accounted for in accordance with the guidance in SOP 02-X and depreciated over the ~~estimated~~expected useful life of the particular improvement.

The last two sentences in the "Property and equipment" paragraph of note 1 in the Grain and Cattle Producer, Inc. illustrative financial statements are deleted. The third sentences of the "Property, plant, and equipment" paragraphs of note 1 in the Central Supply Cooperative and Midstate Marketing Cooperative illustrative financial statements are deleted.

64. This SOP amends the AICPA Audit and Accounting Guide *Audits of Credit Unions*[14] as follows: The first three sentences of paragraph 10.05 are deleted and replaced with the following:

[14] ~~The AICPA has issued an exposure draft of an SOP that~~In December 2001 the AICPA issued SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, which reconciles the specialized accounting and financial reporting guidance established in the existing AICPA Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. The chapters from those Guides have been combined and redrafted for consistency in a proposed Combined Guide, which has been posted to the AICPA web site for comment. Readers should be alert to ~~any final pronouncement.~~

> Costs of property and equipment (excluding interest) should be accounted for in accordance with the guidance in SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*.

65. This SOP amends the AICPA Audit and Accounting Guide *Health Care Organizations* as follows:

The third sentence of paragraph 14.33 is replaced with the following:

> However, costs of acquiring initial continuing-care contracts that are within the scope of SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, should be expensed or capitalized in accordance with that SOP.

The last sentence of paragraph 14.33 is deleted.

Footnote 2 to paragraph 14.33 is replaced with the following:

> Although SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, is superseded with the issuance of this Audit and Accounting Guide, its provisions have been adopted in this chapter.

The second sentence of the "Property and equipment" paragraph of footnote 2 in the Sample Not-for-Profit Health Maintenance Organization illustrative financial statements is deleted.

66. This SOP amends the AICPA Audit and Accounting Guide *Banks and Savings Institutions*[15] as follows:

The last sentence of paragraph 10.11 is deleted, and the third sentence of that paragraph is replaced with the following:

> Capital additions and improvements to premises should be accounted for in accordance with the guidance in SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. Construction period interest should be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost.*

Paragraph 10.15 is replaced with the following:

> Premises and equipment presentation and disclosures should be made in accordance with the guidance in SOP 02-X. The amount of assets under capitalized leases should be disclosed.

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the issuance of a final Combined Guide. [NOTE TO AcSEC: THE GUIDE WILL LIKELY BE ISSUED BEFORE A FINAL SOP ON PP&E. THE GUIDE IS CURRENTLY ANTICIPATED TO BE ISSUED IN THE 3RD QUARTER OF 2002.]

[15] See footnote ~~13.~~8.

67. All of the illustrative financial statements in the AICPA Audit and Accounting Guides will be conformed to the guidance in the "Presentation and Disclosures" section (paragraphs 58 through 60) of this SOP.

68. This SOP supersedes Emerging Issues Task Force (EITF) Issue No. 89-13, "Accounting for the Cost of Asbestos Removal," and EITF Issue No. 90-8, "Capitalization of the Costs to Treat Environmental Contamination."

69. This SOP amends EITF Issue No. 97-11, "Accounting for Internal Costs Relating to Real Estate Property Acquisitions," by changing the scope sentence from

> This Issue does not address the accounting for costs incurred for acquisitions of property that will be used in the enterprise's own operations, other than for sale or rental.

to

> This Issue does not address the accounting for costs incurred for acquisitions of property that will be used for rental or in the enterprise's own operations. It addresses only the accounting for costs incurred for acquisitions of property for sale by the enterprise.

EFFECTIVE DATE AND TRANSITION

70. This SOP is effective for fiscal years beginning after June 15, ~~2002.~~2003. Earlier application is encouraged.

71. For existing PP&E, the component accounting guidance in this SOP should be initially adopted using one of the following alternatives, the election of which should be made and disclosed when the SOP is adopted:

a. Apply component accounting retroactively for all PP&E assets, to the extent practicable, on the adoption date.[16] All components in service at the date of adoption should be assigned a net book value, unless the net book value of the total PP&E asset in service is zero at adoption of the SOP. The allocation of existing net book value to components should be based on original accounting records, if available. If not available, allocation should be based on relative fair values of components as of the date of transition. If allocation based on relative fair value is not practicable, capitalized costs should be allocated based on another reasonable method, such as relative square footage for real estate, as appropriate in the circumstances.

As of the date of adoption, accumulated depreciation for each component should be determined and allocated to the gross book value of that component to ascertain the

[16] Application to assets being accounted for under a group method at time of adoption may not be practicable. See paragraph 56(f) of this SOP.

net book value. Accumulated depreciation by component should be determined by applying a percentage to the gross book value of the component. That percentage is the length of time the component has been in service divided by the total expected useful life of the component. Added or subtracted to such accumulated depreciation by component will be the component's allocable share (based on relative net book values of the components before such allocation) of any difference between the sum of the accumulated depreciation amounts by component for a specific PP&E asset and the amount in the accounting records immediately prior to the application of component accounting. See Example 3 in appendix C for an illustration.

The change (from the PP&E asset not previously accounted for using component accounting) in the expected useful lives of the components would be accounted for prospectively as a change in accounting estimate. A PP&E asset might not be accounted for using component accounting if, for example, determining the components of that asset would be cost-prohibitive and if a reasonable estimate of relative fair values is not available for that asset. For those PP&E assets for which component accounting is not practicable at the date of adoption, the methodology in alternative (b) should be applied.

b. Do not apply component accounting retroactively for any PP&E assets. If this alternative is elected, then in future periods, when an entity incurs capitalizable costs for PP&E that replace all or a portion of PP&E not previously accounted for using component accounting, the entity should estimate the remaining net book value of the asset replaced and charge that amount to depreciation expense in the current period. The methodology in paragraph 53 should be used to estimate net book value.

72. The SOP is to be applied prospectively for all costs incurred after the adoption of the SOP. Costs incurred prior to the adoption of the SOP should not be recharacterized (as capital or expense items) to conform to the guidance in the SOP, with the following exception. Entities applying, prior to the adoption of the SOP, the methods of accounting for planned major maintenance activities listed in paragraph 45 of the SOP should derecognize any planned major maintenance liabilities and conform any planned major maintenance costs deferred to the capitalization guidance in paragraph 44 of the SOP. Entities that, prior to the adoption of the SOP, accrued liabilities for removal costs should derecognize those liabilities. Any adjustments should be recorded as a cumulative effect of a change in accounting principle as of the beginning of the year of adoption.

73. An entity may have a PP&E project that is in the process of being constructed at the date of adoption. The guidance in paragraphs 22 through 41 of this SOP should be applied to the project on a prospective basis beginning with the date of adoption.

The provisions of this Statement need not be applied to immaterial items.

APPENDIX A

BASIS FOR CONCLUSIONS

Scope

A1.The Accounting Standards Executive Committee (AcSEC) excluded from the scope of this AICPA Statement of Position (SOP) property, plant, and equipment (PP&E)-type assets that are accounted for as inventory. AcSEC believes that guidance for those assets (examples include real estate projects constructed for sale under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*) currently exists, and that different accounting for assets for sale versus internal use is acceptable. AcSEC also excluded governmental entities from the scope because it chose not to address the particular applications of the issues in this SOP to state, local, and federal governments.

A1A. The original scope of this project was limited to certain costs associated with real estate that were outside the scope of FASB Statement No. 67. Pursuant to subsequent discussions with both the FASB and the Securities and Exchange Commission (SEC) staff, the project's scope was expanded to provide guidance for all PP&E, including the accounting methods used for planned major maintenance activities.

A2. AcSEC excluded from the scope of this SOP the lessor's accounting for assets that are subject to sales-type or direct financing leases because under those kinds of leases, the leased asset is derecognized on the lessor's balance sheet. AcSEC also elected to exclude from the scope of this SOP lessor or lessee accounting for reimbursements of contractually recoverable expenditures—for example, guidance on whether reimbursements should be accounted for as minimum lease payments or as a reduction of the lessor's cost basis for the asset—and elected instead to refer the user to applicable lease accounting literature. AcSEC is aware that there are a number of different scenarios under which such reimbursements could occur and a number of different ways in which reimbursement arrangements could be structured. AcSEC believes that each such scenario or structure should be evaluated individually, based on facts and circumstances, under the applicable lease accounting guidance, rather than under a single prescribed method in this SOP. AcSEC was concerned that any such method, while potentially reducing diversity in practice, could create conflicts with existing lease accounting literature. AcSEC also believes that it is not practicable within the scope of this SOP to provide guidance for all of the varied and numerous reimbursement scenarios and arrangement structures. However, AcSEC believes that the component accounting provisions of this SOP should apply to all situations in which amounts are capitalized by a lessor or lessee.

A3.AcSEC considered excluding entities that report substantially all assets at fair value (such as companies that are within the scope of the AICPA Audit and Accounting Guide *Audits of Investment Companies*) from the scope of this SOP. However, AcSEC concluded that information on the accounting for costs and activities incurred related to PP&E (that is, whether such costs are capitalized or charged to expense) is important to financial statement users regardless of whether assets are reported at fair value or at historical cost. AcSEC believes that including such entities will result in similar financial statement presentation of similar costs and activities incurred, regardless of whether assets are reported at historical cost or fair value.

A3A.AcSEC considered the impact of this SOP on common interest realty associations (CIRAs). In particular, paragraphs 2.08 to 2.10 of the Audit and Accounting Guide *Common Interest Realty Associations* (CIRA Guide) provide guidance for reporting common real property of CIRAs. The CIRA Guide provides that CIRAs other than cooperatives are permitted to charge to expense, rather than capitalize, the costs of common real property. A CIRA that capitalizes the costs of common real property should follow the guidance in this SOP.

A4.AcSEC considered FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*, and concluded that no conflict with the provisions of this SOP existed because that Statement provided guidance on applying a change in accounting method for railroad track structures from retirement-replacement-betterment accounting to depreciation accounting. Accordingly, the costs of railroad track structures are included within the scope of this SOP.

A5.AcSEC chose not to address the accounting for PP&E-related costs in interim periods. However, concurrent with issuance of this SOP, the FASB is amending Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, which will have the effect of requiring consistent reporting of costs within the scope of the SOP for interim and annual reporting periods (see paragraph 7 of this SOP).

A6.AcSEC believes its conclusions regarding accounting for costs incurred during the preliminary and preacquisition stages do not conflict with the guidance in SOP 98-5, *Reporting on the Costs of Start-Up Activities*. Paragraph 8 of that SOP states that the following costs are outside its scope: “Costs of acquiring or constructing long-lived assets and getting them ready for their intended uses.”

A6A. Some respondents to the exposure draft, particularly respondents in the utility, railroad, and telecommunications industries, commented that regulated industries should be excluded from the scope of this SOP. Those respondents pointed out that entities in regulated industries report in accordance with regulatory accounting requirements and that applying the SOP could result in labor-intensive recording of numerous regulatory assets and liabilities under FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, without any effect on the income statement. AcSEC observed that there are non-regulated entities with accounting issues in those industries that are similar to issues for regulated entities and that those non-regulated entities would have to apply the SOP without the ability to apply FASB Statement No. 71 and thereby not change their income statements. AcSEC believes that the provisions of this SOP should, with very limited exceptions as listed in the scope section, apply to all entities.

A7.Some asked whether AcSEC should propose that the FASB change FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, as amended by FASB Statement No. 25, *Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies*, to conform the accounting for costs in that Statement to the accounting in this SOP. AcSEC chose not to address those issues.

Project Stage Framework

A8.AcSEC considered whether the SOP should provide guidance based on such commonly used classifications as ordinary repairs and maintenance, "extraordinary" repairs and maintenance, replacements, betterments, additions, redevelopments, renovations, rehabilitations, retrofits, rearrangements, refurbishments, or reinstallations. The guidance in the SOP does not rely principally on those or similar classifications. AcSEC believes that such terms would be difficult to define and apply consistently. Based on that conclusion, AcSEC developed the four stages discussed in paragraphs 15 through 21 of this SOP. AcSEC concluded that the guidance in the SOP would be more operational if capitalization criteria were based on the kinds of activities performed and kinds of costs incurred rather than on whether a particular expenditure fits into one of a large number of classification categories.

A8A. A number of respondents to the exposure draft commented that because the kinds of activities performed and costs incurred in the preliminary stage were largely the same as those in the preacquisition stage, the two stages should be combined into a single "preacquisition stage." Many of those respondents commented that costs in that combined stage should be deferred until an entity determines if it proceeding with a particular acquisition or construction project. If the entity were to proceed with the project, those costs would be capitalized as part of the project, subject to impairment testing, and if the entity did not proceed with the project, the costs would be expensed. Many respondents also commented that using a dividing line of "probable" between the first two stages unnecessarily introduces subjectivity into the process. For the reasons indicated in paragraph A15 of this SOP, AcSEC concluded that both keeping the two stages separate and distinct and retaining the "probable" concept are appropriate. AcSEC also noted the precedent with respect to accounting for costs in stages in paragraph 17 of SOP 98-1, *Accounting for the Costs of Computer Software for Internal Use*:

> Regardless, for costs incurred *subsequent to completion of the preliminary project stage*, the SOP should be applied based on the nature of the costs incurred, not the timing of their incurrence. [Emphasis added.]

AcSEC noted further that SOP 98-1 uses the notion of "probable" in paragraph 24 of that SOP and explains its meaning in paragraph 62 of that SOP.

Accounting for Costs Incurred

Other-than-direct costs

A9.In determining the accounting for costs, other than directly identifiable costs, incurred during the four stages, AcSEC considered using the guidance in paragraph 7 of FASB Statement No. 67, which states:

> Project costs clearly associated with the acquisition, development, and construction of a real estate project shall be capitalized as a cost of that project. Indirect project costs that relate to several projects shall be capitalized and allocated to the projects to which the costs relate. 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.

A10. AcSEC also considered the guidance in more recent literature such as FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. Additionally, the guidance in SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use,* was based on the guidance in FASB Statement No. 91. FASB Statement No. 91 states:

> Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender…The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities…All other lending-related costs…shall be charged to expense as incurred…Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

A11. In AcSEC's judgment, the more recent literature represents an evolution of the less detailed guidance of FASB Statement No. 67, and therefore AcSEC analogized to that more recent literature in its conclusions on the treatment of indirect and overhead costs. AcSEC developed the guidance in this SOP based on consideration of the guidance in SOP 98-1 by concluding that overhead costs should not be capitalized. Although some may argue that the benefits of accumulating and assigning the costs of overhead and support functions might exceed the costs of accumulating and assigning such costs in the case of significant PP&E expenditures, AcSEC was concerned that overly aggressive allocations of such costs may have occurred in the past. AcSEC also believes that allocation of indirect and overhead costs to PP&E development projects, thus removing them from period costs, could affect the period-to-period comparability of income statements. AcSEC decided to provide guidance in this SOP that is based on the guidance in FASB Statement No. 91 and SOP 98-1.

A12. AcSEC concluded that general and administrative costs and overhead costs should be charged to expense as incurred, regardless of whether such costs are incurred internally by the entity or specifically outsourced to another enterprise on behalf of the entity. That conclusion is based on the observation that costs of a similar nature should be accounted for consistently. For example, an entity may either choose to employ an internal information systems department or to outsource this support function to a third party. The decision to outsource is a business decision, but the nature of the costs incurred is the same.

Preliminary stage

A13. AcSEC concluded that payments to acquire options for PP&E should be capitalized, because those rights can be identified to a specific item of PP&E and meet the definition of an asset under FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*.

A14. AcSEC considered three alternative methods of accounting for all other costs incurred during the preliminary stage:

a. Charge all costs to expense as incurred.
b. Capitalize all costs as incurred.
c. Capitalize costs as incurred if specified conditions are met and charge all other costs to expense.

A15. In concluding that all preliminary stage costs (except option costs) should be charged to expense when incurred, AcSEC considered the following factors:

a. Whether preliminary stage costs (other than payments for options to acquire PP&E) meet the definition of an asset. There is a high degree of uncertainty about the future benefits of costs incurred prior to a project becoming probable. Evaluation of historical experience was considered, but AcSEC concluded that historical experience is not necessarily indicative of future results and therefore it is not sufficient, in and of itself, to support recognition of an asset. In other words, there is no indication at the time they are incurred that preliminary stage costs create an economic resource that will generate a probable future benefit.

b. Entities undertake preliminary stage activities with the expectation of future benefits. If there were no such expectation, the activities would not be conducted. Some believe that the accounting for preliminary stage costs should be determined by considering in the aggregate all of the preliminary projects of an enterprise. Under that view, if there is a high probability of future benefits from an entity's total preliminary activities, the entire cost of those activities should be capitalized without regard to the certainty of future benefits from individual projects. AcSEC concluded, however, that it is not appropriate to consider preliminary stage costs on an aggregate or total-enterprise basis for several reasons. For accounting purposes, the expectation of future benefits is generally not evaluated in relation to broad categories of expenditures on an entity-wide basis but rather in relation to an individual project. Also, an entity's pool of preliminary stage activities may consist of a number of projects at varying stages and with varying degrees of uncertainty as to their ultimate success. If preliminary stage costs were capitalized on an entity-wide basis, a meaningful method of amortization could not be developed because the period of benefit could not be determined.

c. Selective capitalization—capitalizing certain preliminary stage costs as incurred if specified conditions are met and charging to expense all other preliminary stage costs—requires establishment of capitalization criteria. AcSEC does not believe it could determine operational criteria that would be consistently and objectively applied.

d. Some AcSEC members believe that preliminary stage costs are analogous to research and development costs or start-up costs, which are charged to expense as incurred.

e. As noted in paragraph A8A, some respondents commented that impairment testing under FASB Statement No. 144, applied to capitalized preliminary stage costs, would resolve issues of potential uncertainty of future benefits by reflecting uncertainty through recognition of an impairment loss. AcSEC believes, however, that because of that uncertainty FASB Statement No. 144 does not apply, as that Statement applies only to long-lived assets and AcSEC does not believe that preliminary stage costs meet the definition of an asset, let alone a long-lived asset.

Based on the above, AcSEC concluded that preliminary stage costs (other than payments for options to acquire PP&E) should be charged to expense as incurred.

Preacquisition stage

A16. AcSEC's conclusions regarding treatment of costs incurred during the preacquisition stage are based on the guidance in paragraphs 4 and 5 of FASB Statement No. 67, the guidance in paragraph 6 of FASB Statement No. 91, and the questions and answers relating to paragraphs 6, 7, and 10 in the FASB Staff Implementation Guide *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.

A17. AcSEC's conclusion in paragraph 27 of this SOP regarding a rebuttable presumption of zero fair value for an asset comprised of capitalized preacquisition stage costs is based on an analogy to paragraph 32 of SOP 00-2, *Accounting by Producers or Distributors of Films*. AcSEC believes this is an appropriate analogy because the majority of the costs incurred in this stage are "soft" costs that may generate only some limited intangible value. When it is no longer probable that a project will proceed, the fair value of those deferred costs, without a clear decision and plan to sell, is questionable and, therefore, AcSEC concluded that an asset should no longer be recorded.

Acquisition-or-construction stage

A17A. A number of respondents to the exposure draft commented that the SOP should be based on a cost model under which all costs, other than general and administrative expenses, that are "clearly associated" with the construction or acquisition of specific PP&E should be capitalized. Those respondents point out that similar models are used in ARB 43 for inventory accounting and in FAS 67 for real estate for sale. The respondents note that adoption of such a cost model in this SOP would eliminate (a) the difference, other than profit margin, between the recorded amounts for an internally constructed PP&E asset and that same asset purchased from an independent third party, and (b) the necessity of having different costs bases and administering different cost systems for PP&E-type assets that an entity produces in a situation where some assets may be for sale, some for internal use, some for lease under an operating lease, and some for lease under a sales-type lease. Some respondents commented that expensing indirect and overhead costs understates the true PP&E cost and therefore there is not an appropriate matching between the costs of the PP&E and the revenues generated from the entity's use of the PP&E. Some of those respondents commented that long-lived-asset impairment testing required under GAAP would take care of any necessary reductions in the recorded value of PP&E.

A17B. With respect to impairment testing, AcSEC observed that under FAS 144, an impairment test is applied to the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities, and, therefore may not be applicable to many PP&E assets (particularly non-real-estate assets). AcSEC also was not convinced that the accounting for PP&E costs should necessarily be the same as the accounting for inventory costs. Under ARB 43, for example, inventory accounting includes a lower-of-cost-or-market test, which does not exist for PP&E assets, that acts as a "ceiling" on the amount of costs that an entity can capitalize as inventory. In addition, AcSEC observed that inventory generally turns over quickly compared with PP&E. As a result, overhead costs capitalizable as inventory typically flow through the income statement relatively quickly as cost of sales as compared with the rate that such costs capitalizable as PP&E would flow through the income statement as depreciation expense. Under the PP&E cost model in this SOP, AcSEC believes that overhead, being charged to expense as incurred, actually flows through the income statement at a rate *more* comparable to inventory and cost of sales than if overhead was capitalized as a cost of PP&E.

A17C. AcSEC believes that the direct and incremental cost model, as applied under FAS 91, is the appropriate cost model for PP&E. That is, the costs of an entity's functional activities that are incremental to the entity's activities of acquiring or constructing assets (but not necessarily incremental to a specific acquired or constructed asset) should be capitalized. Consider an entity that constructs PP&E assets for rental or internal use and has a two-person engineering department to design the PP&E. The engineers' time and reimbursed travel costs identified with specific PP&E projects is assigned to those projects by means of the entity's payroll, accounts payable, and general ledger systems. The entity and its engineers are involved in twenty PP&E projects on average at any given time, and the entity will add a third engineer to its staff only if the average number of projects reaches thirty. AcSEC believes that the engineers' payroll and payroll benefits costs and travel costs are capitalizable to specific PP&E projects because those costs are incremental to the entity's PP&E construction activities despite there not being a one-to-one correspondence between engineers and projects. A similar argument would apply to a cost accounting staff whose time is allocable to specific PP&E projects. On the other hand, AcSEC does not believe that, for example, a chief financial officer's time would typically be capitalizable as "incremental" because no matter how many PP&E projects a company takes on, it is unlikely that it will hire a second chief financial officer. AcSEC believes, however, that incremental and other costs capitalized to PP&E projects that do not come to fruition in terms of resulting in a completed PP&E asset should be charged to expense when it is no longer probable that the asset will be completed.

A17D. AcSEC was not convinced by respondents who commented that profit margin should be the only difference between the cost of an internally constructed PP&E asset and that same asset constructed by an outside third party. AcSEC believes that an internally constructed asset may not be comparable based on cost alone to the "same" asset constructed by an outside third party because (a) the entity may have the infrastructure in place to construct the PP&E for less than what an outside third party would charge, whether or not indirect and overhead costs are considered, (b) the outside third party may not have the expertise that the entity possesses to construct the PP&E asset in question (or vice versa), or (c) an entity may be constrained—for example, by labor union contracts—to construct the assets internally. With respect to item (a), an entity involved in a make-versus-buy decision for PP&E typically considers, from a cost perspective, only those costs that an entity would incur incrementally in constructing the PP&E. AcSEC does not believe that an entity capable of constructing at a lower cost than that charged by an independent third party would typically spend a higher amount for that third party merely to defer recognition of overhead expense. In short, AcSEC believes that there may be many factors involved in a make-or-buy decision and that an entity must weigh cost considerations against other factors.

A18. In concluding in paragraph 28(b) that depreciation of machinery and equipment used directly in the construction or installation of PP&E should be capitalized, AcSEC analogized to the guidance for certain development costs in paragraphs 21, 22, and 26 of FASB Statement No. 19. AcSEC did observe, however, that the guidance in paragraph 31 of SOP 98-1 does not allow capitalization of depreciation. Although AcSEC analogized to SOP 98-1 with respect to overhead-type costs and costs (other than depreciation) of machinery and equipment used in the construction or installation of PP&E, AcSEC concluded that the nature of depreciation of existing machinery and equipment used to construct PP&E during the acquisition-or-construction stage is more similar to the nature of depreciation costs for equipment used in oil and gas producing activities. AcSEC also observed that such depreciation is directly identifiable with the PP&E being constructed, and that an entity would be allowed to capitalize the rental cost of similar equipment if it did not utilize its own equipment. Therefore, AcSEC concluded such depreciation costs are similar in nature to the rental cost of third-party equipment used to construct PP&E, and should be treated similarly.

A19. AcSEC concluded that an entity's existing inventory~~(including spare parts)~~ used to construct PP&E or that is converted into PP&E should be capitalized during the acquisition-or-construction stage. AcSEC observed that conversion of existing inventory into PP&E reasonably represents an incremental direct cost. AcSEC concluded that the timing of the expenditure should not change the treatment of the cost, and therefore capitalization of inventory used in the construction of PP&E is appropriate.

A19A. AcSEC believes that the SOP's requirement to expense as incurred the costs of an entity's acquisitions function is consistent with the conclusions of paragraph 33 of AICPA Accounting Interpretation AIN-APB16, *Business Combinations*, and EITF 97-11, "Accounting for Internal Costs Relating to Real Estate Property Acquisitions."

A20. AcSEC's conclusions in paragraph 32 relating to costs incurred for property taxes, insurance, and ground rentals were based on AcSEC's belief that those costs are directly identifiable to a project and avoidable costs of construction that should be included in the cost of the property just as qualifying materials, labor, and interest cost are included. AcSEC analogized to FASB Statement No. 34, which indicates that interest cost should be included as a part of the cost of assets because it is an avoidable cost—had the entity not constructed the asset it could have avoided the interest cost by using the construction expenditures to instead repay debt. Similarly, and by analogy, had the entity not constructed the property, it could have avoided the property taxes, insurance, and ground rentals associated with the construction. AcSEC does not believe that the "avoidable costs" concept should be extended to costs other than property taxes, insurance, and ground rentals. AcSEC also considered the model in FASB Statement No. 91, which addresses more broadly the accounting for certain costs, for possible analogy to the costs of property, taxes, insurance, and ground rentals, but elected to analogize to the interest cost model of FASB Statement No. 34.

A21. Some believe that these costs should be capitalized only if the property to which they relate is newly purchased, thus demonstrating that the costs are incremental. AcSEC concluded that the past status of the property under construction should not affect the accounting for ground rent, property taxes, and insurance during construction, just as the past status of the property does not affect the accounting for interest cost during construction. If property is newly acquired specifically for the purpose of construction, then the ground rent, property taxes, and insurance are both avoidable and incremental costs of construction. If the property has been used in the past as an operating asset, but is removed from operations for purposes of construction, the ground rent, property taxes, and insurance are avoidable costs of construction, even though they are not incremental to the entity. The entity could avoid the ground rent, property taxes, and insurance by choosing to dispose of the property.

A22. If the property under construction remains in operation during construction, then AcSEC concluded that the ground rent, property taxes, and insurance associated with the operating property should be charged to expense as incurred. In that situation, the existing ground rent, property taxes, and insurance are costs of operations, not avoidable costs of construction. Until the entity ceases operations of the property, it is not in a position to avoid those costs by disposing of the property. If the entity incurs identifiable incremental property taxes or insurance that are directly attributable to the construction activities, AcSEC believes those incremental costs are avoidable costs that should be capitalized as part of the cost of the asset under construction.

A23. Consistent with FASB Statement No. 34, AcSEC also concluded that the capitalization period should commence when the asset is no longer in operations and "activities necessary to get the property ready for its intended use" commence, and should cease when those activities are suspended, when the asset is placed back into operations, or when the asset is "substantially complete and ready for its intended use," whichever comes first. AcSEC believes that approach properly identifies the periods in which ground rent, property taxes, and insurance are avoidable costs of construction. In addition, AcSEC perceived that approach to be well understood in practice and operational.

A24. AcSEC concluded that, in general, costs related to tenant or leasehold improvements in a multifloor building should be appropriately capitalized by the lessor on a tenant-by-tenant basis. However, AcSEC concluded in paragraph 32 of this SOP that costs incurred for property taxes, insurance, and ground rentals relate to the building and land as a whole and therefore the cessation of capitalization of those costs should occur when the building is substantially complete and ready for its intended use (but no later than the date initial operations commence) rather than being phased in over time as the tenant or leasehold improvements in the building are completed. AcSEC believes that once a building shell is complete, the process of obtaining tenants and constructing leasehold improvements for those tenants is an ongoing cost of lessor operations and that the building is substantially complete and ready for its intended use in rental operations.

A25. AcSEC concluded in paragraph 33 of this SOP that demolition costs should be capitalized as a cost of the real estate when the demolition is ~~contemplated as part~~probable at the time of the acquisition of real estate and occurs within a reasonable period of time thereafter. Under those circumstances, it is clear that the cost of the real estate includes both the purchase price and the costs the buyer is willing to pay to demolish the real estate to prepare it for its intended use.

A26. AcSEC also concluded in paragraph 33 of this SOP that whether the demolition costs are capitalized to land or building depends on the nature of the costs. That conclusion was intended to cover both the situation in which (a) an entity acquires land with a building on it and demolishes the building in order to prepare the site for new construction, and (b) an entity acquires a building previously used for one purpose and demolishes the interior in order to prepare the building for a different use. Provided that the conditions for capitalization in paragraph 33 are met, in (a) the demolition costs would be capitalized as part of the cost of the land, and in (b) they would be capitalized as part of the cost of the building.

A27. AcSEC's conclusion in paragraph 34 of this SOP regarding when PP&E is considered substantially complete and ready for its intended use, and the treatment of operating costs after that point, is based on the guidance in paragraph 22 of FASB Statement No. 67. AcSEC recognized that paragraph 22 of FASB Statement No. 67 provides for up to a one-year delay (for completion of tenant improvements) in the recognition of depreciation when a rental real estate project is substantially complete. However, AcSEC concluded that this one-year allowance was arbitrary, and could not be applied consistently to all PP&E; therefore, AcSEC elected instead to use the completion of all major construction activities, or when related revenues begin to be recognized, if sooner, as the basis for considering PP&E to be substantially complete and ready for its intended use. AcSEC also believes its conclusion in paragraph 34 of this SOP is consistent with paragraph 18 of FASB Statement No. 34.

A28. AcSEC's conclusions in paragraphs 32 and 34 of this SOP relating to expensing property taxes, insurance, and ground rentals once operations related to PP&E begin are based on AcSEC's belief that the beginning of operations is an objective indicator that PP&E is substantially complete and ready for its intended use.

A29. AcSEC's conclusion in paragraph 35 of this SOP regarding accounting for a project that has portions that are capable of being operated independently from other portions is based on an analogy to paragraphs 11 and 23 of FASB Statement No. 67.

In-service stage

A30. Some believe that certain in-service stage expenditures—significant costs that do not meet the criteria for capitalization specified in the SOP and do not need to be incurred again for years—should be recorded as prepaid expenses, deferred costs, or a new PP&E component. The logic supporting those approaches is that such costs benefit one or more future periods and should be amortized over the estimated time of benefit until similar costs are incurred again, and that failure to incur those costs might significantly reduce the life of the PP&E asset to which they relate. Those individuals believe that the costs could be considered to extend the expected useful life of the PP&E asset and, therefore, should be capitalizable.

A31. AcSEC considered extensions of expected useful life as a capitalization criterion. However, AcSEC believes that the determination of an expected useful life of a PP&E asset is based on a presumption that an entity will perform normal, ongoing or periodic required maintenance activities on that asset over its life. As such, AcSEC concluded that costs incurred to restore PP&E to its original operating condition do not provide a future benefit but rather remedy the effects of having used the PP&E in the past and allow the PP&E to continue in use through its full expected useful life. AcSEC also believes that a PP&E-related cost should not qualify for capitalization simply because it is a large monetary amount or it does not occur on a recurring basis. AcSEC concluded that it is appropriate to limit the acceptable accounting treatments of costs relating to PP&E to (a) capitalizing them as fixed assets if they meet the capitalization criteria of this SOP or (b) charging them to expense as incurred. AcSEC believes that this approach is operational and will lead to greater consistency of financial reporting between entities.

A32. AcSEC concluded in paragraph 39 of this SOP that, in conjunction with a replacement of a~~subcomponent, removal costs should be charged to expense, including costs of disassembly of a component to gain access to the subcomponent. Based on paragraph 28 of this SOP, certain of the component's reassembly costs associated with the replacement should be capitalized. AcSEC's conclusion on removal costs is based on the observation~~component, removal costs that meet the SOP's capitalization criteria should be capitalized as part of the replacement. In the exposure draft, removal costs were to be charged to expense as incurred based on the notion that removal costs are the last costs in the life cycle of an asset and should remain associated with the removed asset rather than being capitalized into the cost of the replacement asset. ~~Some~~However, as many respondents commented, separating the removal costs of the replaced component from the installation costs of the ~~believe that separating the disassembly costs of the component from the reassembly costs of that same component could be difficult in practice and that, therefore, the two kinds of costs should not be accounted for differently. While acknowledging that concern, AcSEC decided that (a) because disassembly costs were associated with the removal of the replaced subcomponent, those costs should be charged to expense, just as the remaining net book value of the replaced subcomponent is charged to expense, and (b) reassembly costs should be associated with the replacement and should be accounted for as installation costs in accordance with paragraphs 28 and 37 of this SOP. AcSEC believes that reasonable estimates of those two different aspects of replacing a component can be made.~~replacement could be difficult in practice. AcSEC concluded that, in view of an entity's removal of a component being an integral part of the process of replacing it, the cost of removing the component should be included as a cost of the replacement.

A33. AcSEC's conclusion in paragraph 41 of this SOP that in-service stage incremental direct costs should be capitalized if the costs are related to a contractual agreement for the sale of PP&E that obligates an entity to incur costs in the future to effect the ultimate sale is based on ~~paragraph 16~~paragraphs B81 and B82 of FASB Statement No. ~~121.~~[1]144.

A34. In concluding in paragraph 38 of this SOP that if PP&E or components are replaced and the replacements are capitalized, the net book value of the replaced items should be charged to depreciation expense, AcSEC observed that an asset that is no longer in service or otherwise being used by an entity will not provide the entity with a probable future benefit and should not remain capitalized in the entity's accounting records. AcSEC concluded that the net book value should be charged to depreciation expense because this charge results from an adjustment to the expected useful life of the PP&E.

~~[1] The Financial Accounting Standards Board (FASB) has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that would supersede FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. Readers should be alert to any final pronouncement.~~

Planned major maintenance activities

A35. The accounting for the costs of planned major maintenance activities was intended to address the propriety of and disparity among the various methods that were being used to account for such costs. The AICPA Industry Audit Guide *Audits of Airlines*, for example, listed different methods considered acceptable in accounting for airline overhaul costs. Those methods can be summarized as follows:

a. *Expense as incurred*. This method is based on the fact that the costs are relatively consistent from period to period, that they are not separately identifiable assets or property units in and of themselves, and that they serve only to restore other assets to their original operating condition.

b. *Accrue in advance*. Under this method, an estimate is made of the costs expected to be incurred in the future in connection with the next planned periodic maintenance shutdown. The estimate is then accrued as a liability in a systematic and rational manner over the period of time until the next planned major maintenance activity occurs. Any difference between the costs actually incurred in connection with performing the activity and the accrued liability is charged or credited to expense at the time that the activity occurs.

c. *Defer and amortize*. Under this method, the actual cost of each planned major maintenance activity is capitalized and amortized to expense in a systematic and rational manner over the estimated period until the next planned major maintenance activity.

d. *Built-in overhaul*. This method entails current recognition of additional depreciation or amortization to cover the future costs of the planned major maintenance activity. Under this method, cost of activities that restore the service potential of PP&E are considered capitalizable. The cost of PP&E (upon which the planned major maintenance activity is performed) is segregated into those costs that are to be depreciated over the expected useful life of the PP&E and those that represent the estimated cost of the next planned major maintenance activity. Thus, the estimated cost of the first planned major maintenance activity is separated from the cost of the “remainder” of the PP&E, much like a component with a separate useful life, and amortized to the date of the initial planned major maintenance activity. The cost of the initial planned major maintenance activity is then capitalized and amortized to the next occurrence of the planned major maintenance activity, at which time the process is repeated.

A36. Some preferred the expense-as-incurred method to be the only permitted accounting for planned major maintenance activities. Those expressing this preference pointed to Emerging Issues Task Force (EITF) Issue No. 90-8, "Capitalization of the Costs to Treat Environmental Contamination," which permitted capitalization of recoverable environmental treatment costs associated with certain types of activities performed on property of an entity provided that the condition of the property after the costs are incurred is improved as compared with the condition of that property when initially constructed or acquired, if later. Because it can be argued that planned major maintenance activities merely restore, rather than improve, the condition of PP&E, they analogized that those activities should be charged to expense. AcSEC was not convinced that guidance for environmental cleanup costs, because of the nature of the costs incurred and activities performed, should necessarily be extended by analogy to guidance for component accounting of planned major maintenance activities. AcSEC believes that certain of the parts or components that may be replaced during those major maintenance activities may meet the capitalization criteria of this SOP. AcSEC also believes that applying the component accounting guidance of this SOP to the costs and activities of planned major maintenance activities was a natural extension of the guidance in this SOP.

A37. AcSEC rejected the accrue-in-advance method because AcSEC does not believe that estimated future repair and maintenance costs represent a liability as defined in FASB Concepts Statement No. 6. Specifically, prior to the performance of the planned major maintenance activity, an entity does not have a present unavoidable duty or responsibility to sacrifice assets in the future. Moreover, AcSEC does not believe that there has been an obligating event prior to the maintenance activities being performed.

A38. AcSEC rejected the deferral and built-in overhaul approaches because it does not believe that all of the costs incurred as part of a planned major maintenance activity are capitalizable in accordance with criteria set forth in this SOP. For the same reason, AcSEC rejected the approach taken in the International Accounting Standards Committee's Standing Interpretations Committee Interpretation D23, *Property, Plant and Equipment—Major Inspection or Overhaul Costs*. That Interpretation says that although overhaul costs are generally expensed, those costs are capitalized if (a) an entity has identified as a separate PP&E component an amount representing an overhaul and has already depreciated that component to reflect the consumption of benefits replaced or restored by the subsequent overhaul and (b) the criteria for recognition of an asset are met. AcSEC believes it is essential to maintain consistency in this SOP between the accounting for the costs of repairs and maintenance, additions, and replacements incurred in conjunction with planned major maintenance activities and the accounting for those costs when incurred in conjunction with activities other than planned major maintenance activities.

A39. Replacing a component that has a shorter expected useful life than that of the rest of the PP&E asset is contemplated in estimating the useful life of the rest of the asset. For example, if the roof of a building is not replaced when it wears out, the remaining useful life of the rest of the structure could be significantly affected. Likewise, not conducting planned major maintenance activities could significantly shorten the remaining useful life of a PP&E asset. For example, not overhauling a jet engine could significantly shorten the remaining useful life of the airframe of an airplane. Some believe that service potential is the essence of a nonmonetary asset and represents the ability to contribute to future net cash inflows. They believe that depreciation is an accounting method intended to allocate the cost of an asset over the period its service potential is consumed and, as with component accounting, that it is appropriate to allocate certain costs of PP&E over different periods. Accordingly, they believe the objective of the built-in overhaul method is appropriate and that giving further consideration to improving how that method is applied is preferable to abandoning it.

A40. However, AcSEC rejected the built-in overhaul method also because it does not believe that planned major maintenance activities increase the service potential of PP&E. Rather, AcSEC believes that in making the initial determination of the expected useful life (service potential) of a PP&E asset, an entity takes into account that it will perform repairs and maintenance activities, including planned major maintenance, at the appropriate times. If those activities had not been contemplated in the determination of expected useful life, that life would likely have been determined to be significantly shorter.

~~**Use of Inventory in Production of Internal-Use PP&E**~~A40A. Some respondents commented that an entity could avoid expense treatment in a situation where a removable component of PP&E—for example, an engine—requires an overhaul every several years. Rather than overhauling the engine, much of which would get expensed, the entity would replace the engine with an overhauled engine, much of which would be capitalized. AcSEC believes that scenario is possible but that an entity's overhaul-or-replace business decisions should not and would typically not be solely based on an accounting pronouncement. AcSEC also noted that in the scenario described, the engine's expected useful life would be reduced from the number of years that the engine would be expected to last (assuming appropriate overhauls were performed) to the number of years between overhauls, thereby offsetting the reduced maintenance expense with increased depreciation expense.

Inventory and Leasing Considerations for PP&E-Type Assets

A41. AcSEC discussed the situation in which an entity originally classifies an asset as inventory (for which the accounting is not within the scope of this SOP), but subsequently determines that the asset will be utilized as a productive asset. AcSEC's conclusion in paragraph 47 that a pattern of changing the intended use of assets from inventory to PP&E during the acquisition-or-construction or in-service stages creates a rebuttable presumption that any such assets subsequently produced by the entity are intended to be used as PP&E (and, therefore, should be accounted for in accordance with this SOP) is based on paragraph 40 of SOP 98-1. AcSEC observed that a pattern of changing the intended use of self-constructed assets from inventory to PP&E (for example, an entity with a pattern of changing the intended use of self-constructed apartment buildings from inventory to PP&E) creates a presumption that the assets being constructed are actually PP&E, which would require application of this SOP.

A42. AcSEC further observed that there are many situations in which an entity manufactures fungible inventory (for example, steel, insulation, computers, or automobiles), and then subsequently utilizes a small portion of that production for its own purposes rather than selling it. AcSEC concluded that those kinds of situations do not change the fundamental nature of the entity's operations (that is, manufacturing assets for sale in the ordinary course of business), and, therefore, inventory accounting principles should continue to be applied to the production of those assets.

~~PP&E-Type Assets Produced for Sale or Operating Lease~~

A43. AcSEC recognizes that some entities routinely manufacture products, some of which are sold directly and some of which are leased to lessees under sales-type leases whereas others are leased to lessees under operating leases. In some cases, the entity does not know what form the transaction will take until it occurs and the customer decides whether its acquisition of product will be accomplished through a purchase or lease. AcSEC believes that in these situations, an entity should accumulate costs differently for such assets based on whether the asset is sold outright or leased to a lessee under a sales-type lease (in either case, inventory cost accumulation requirements would apply) or leased to a lessee under an operating lease (in which case AcSEC believes the cost accumulation provisions of this SOP should apply).

Component Accounting

A44. AcSEC considered composite depreciation as an alternative to component accounting. Composite depreciation is defined as a process of averaging the service life of a number of property units and taking depreciation on the entire lot as if it were an operating unit. AcSEC chose component accounting rather than the composite method for a number of reasons:

a. Component accounting more precisely allocates the cost of PP&E to the periods benefited by that PP&E.

a1. Under component accounting, a component is considered to be the lowest level of fixed asset. This SOP requires charging to expense as incurred all costs of parts of a component below that level. Those costs are considered to be repairs and maintenance that is performed in order to enable the component to last and be usable throughout its expected useful life. A composite-life concept is inconsistent with that fundamental concept of component accounting.

b. A composite life may not be determined with a high degree of precision and may not reflect the weighted average useful lives of the PP&E asset's principal components.

c. The composite approach may conceal inaccurate estimates of expected useful life for long periods.

d. By not recognizing gains or losses, the approach may not correct for changes in asset usage or other factors affecting actual useful lives as compared to expected useful lives.

e. Control over PP&E may be reduced because detailed records may not be used.

f. If individual property units become idle, depreciation on those idle units may not be determined with the same precision as if those units were depreciated individually.

In view of the above reasons, AcSEC concluded that the composite method is not acceptable.

A45. AcSEC's conclusion that a component having an expected useful life different from the life of the overall PP&E asset to which it relates should be depreciated separately is based on the resulting more precise allocation of the cost of the component and remaining PP&E asset over the periods of expected benefit. AcSEC discussed further how, if the expected useful life of a portion of a PP&E asset is similar to the remaining PP&E asset, and that portion is separately distinguishable and may be replaced separately from the remaining PP&E asset, an entity may want to account for that portion as a separate component as well. For example, although the roof of a building having an expected useful life of thirty years may itself have an expected useful life of thirty years, an entity may want to separately account for the roof as a component in its books and records. AcSEC believes that this is reasonable and should be encouraged.

A45A. AcSEC's conclusions in paragraph 51 of this SOP related to the assignment of costs to components are based on the guidance in paragraph 11 of FASB Statement No. 67.

A46. AcSEC considered an alternative to its conclusion in paragraph 51 of this SOP that when an entity capitalizes a replacement of a part or portion of PP&E that was not originally accounted for as a separate component, the net book value of that part or portion (or a reasonable estimate if the net book value is not separately determinable from the accounting records) must be charged to depreciation expense in the period removed from service. The alternative was to require that, when an entity replaces a part or portion of PP&E that was not originally accounted for as a separate component, the entity must charge the cost of the replacement to expense in the period incurred. AcSEC decided against that alternative because it believes that entities would, as a practical matter, not be able to anticipate and initially apply component accounting in every possible manner and configuration in which replacements occur. For example, suppose an entity chose to apply component accounting to a multiwing building by function (for example, roof or HVAC system) and later replaced an entire wing of the building with a larger wing. In so doing, the entity replaced a portion of the roof or HVAC system for that wing only. Because the entity did not originally apply component accounting by wing, some believe that the result of applying the alternative accounting treatment could be that the entire new wing would have to be charged to expense, a result that AcSEC found troubling. AcSEC believes that entities should be able to make reasonable and reliable estimates of the net book value of components of PP&E that are replaced and that the accounting in this SOP provides the most representationally faithful result.

~~A47. AcSEC's conclusions in paragraph 50 of this SOP related to the valuation of components are based on the guidance in paragraph 11 of FASB Statement No. 67.~~

~~A48. AcSEC acknowledges that entities have developed and utilized in practice various accounting conventions, including group depreciation and the use of composite lives. Group depreciation methods depreciate the cost of a large group of homogeneous assets over an average useful life. To the extent that an entity can demonstrate that those conventions can be used and produce results related to gross PP&E, accumulated depreciation, depreciation expense, and gains or losses on replacements or disposals of PP&E that are not materially different from those obtained under the component accounting prescribed in paragraphs 49 through 56 of this SOP, such practices are not precluded.~~A47. AcSEC concluded in paragraph 53 of this SOP that concurrent with replacement of an item not previously considered to be a separate component, but considered going forward to be a separate component, an entity should reevaluate the level of component accounting and associated lives of the components of the remaining PP&E asset and similar assets. AcSEC believes that requiring such reevaluation is important in order to preclude an entity from arbitrarily applying component accounting to one item of PP&E and not applying component accounting to a similar item.

A49. AcSEC did not address the impact of component accounting on the evaluation of impairment of PP&E under FASB Statement No. ~~121,~~144, as AcSEC considered that issue outside the scope of this SOP.[2]

Liquidated Damages

~~A50. AcSEC~~A50. AcSEC concluded in paragraph 57 of this SOP that a purchaser of PP&E should account for a receipt of liquidated damages from the seller as a reduction of the cost of the PP&E. AcSEC believes that treatment appropriately records the PP&E at cost, with the liquidated damages being an adjustment to the cost of the PP&E. AcSEC views liquidated damages to be a "mirror image" of bonuses paid to contractors for early completion of assets, which in practice generally are capitalized as an additional cost of the property, and believes that the accounting should be symmetrical. AcSEC notes that many contracts could be drafted in two ways—a realistic completion date and contract price with liquidated damages for late delivery, or a pessimistic completion date and a bargain contract price with a bonus for early delivery—and that accounting for liquidated damages as a reduction in the cost of the PP&E results in the same accounting regardless of how the contract is drafted. The prescribed accounting is consistent with the guidance in EITF Issue No. 85-27, "Recognition of Receipts from Made-Up Rental Shortfalls." AcSEC believes the accounting to be relatively simple and straightforward to apply in comparison with alternative accounting treatments. AcSEC also concluded that liquidated damages received from the seller in excess of total PP&E cost should be recognized as income. AcSEC observes that the receipt of such excess liquidated damages does not represent a liability, as the purchaser

[2] See footnote 1 of this appendix.

has no obligation to the seller. Therefore, those amounts are appropriately recorded as income.

A51. AcSEC considered three alternative accounting treatments:

a. Record the liquidated damages as income.

b. Record the liquidated damages as income up to the amount of costs incurred by the buyer that are directly attributable to the delay. Liquidated damages in excess of those costs are recorded as a reduction of the cost of the PP&E.

c. Record the liquidated damages as a reduction of the cost of the PP&E up to the amount of costs capitalized by the buyer that are directly attributable to the delay. Liquidated damages in excess of those costs are recorded as income.

AcSEC acknowledges that recognition of all or part of liquidated damages in income, which all three alternatives encompass, could be argued. Liquidated damages (a) may be viewed as having similarities to business interruption insurance, the proceeds of which are recorded in income as earned, (b) are negotiated in advance for simplicity but may be viewed in concept as partially a reimbursement of costs and partially a penalty that should be reported as income, and (c) result in what some may perceive as a more accurate recording of fair value of the PP&E because the delay does not reduce the fair value. However, AcSEC rejected the alternatives for several reasons. If liquidated damages were recorded as income, then symmetry would require all or some portion of incentive payments for early delivery to be recorded as an expense, which AcSEC does not consider appropriate. AcSEC was not persuaded by the analogy to business interruption insurance, because liquidated damages are negotiated in advance and do not purport to reimburse actual costs. AcSEC believes recording a portion of liquidated damages in income treats the transaction as a multiple-element arrangement even though the contract does not meet the normal requirements for separating the arrangement into its elements and no part of the buyer's payments are treated as insurance premiums. Finally, AcSEC believes that its conclusion is the most operational treatment.

Presentation and Disclosures

A51B. AcSEC believes that the PP&E category disclosures required in paragraph 58 of this SOP are consistent with paragraph 5(b) of "Disclosure of Depreciable Assets and Depreciation" in APB Opinion No. 12, *Omnibus Opinion—1967*.

A51C. Some respondents disagreed with the SOP's repairs and maintenance (R&M) disclosure requirement. They commented that such disclosure will neither provide useful information nor result in comparability among entities due to a lack of specific guidelines and definitions in the SOP and due to the fact that each entity has different expense/capitalization thresholds. Examples cited of such lack of guidelines included the absence of a definition of "R&M" in the SOP and the absence of guidance regarding whether overhead costs can or should be included in R&M expense. AcSEC believes the R&M disclosure requirement be retained because an entity may not categorize R&M expenditures under a financial statement caption labeled "R&M." Some or all of those expenditures might be included in payroll or general and administrative expenses or another financial statement caption, and the task force believes it is important for a financial statement user to be able to determine the magnitude and nature of R&M—for example, in order to detect and understand apparent trends.

Effective Date and Transition

A52. AcSEC's basis for permitting an entity to elect whether it would retroactively apply component accounting at transition was that it believes that retroactive component accounting may be perceived to be burdensome and cost-prohibitive for certain entities. However, AcSEC also believes that entities that have the resources and the desire to perform retroactive component accounting should not be precluded from doing so as it results in a more precise allocation of costs and an improvement in financial reporting.

A53. AcSEC's conclusion that costs incurred prior to the adoption of this SOP should not be recharacterized to conform with the capitalization guidance of this SOP is based on the belief that such a requirement would not be cost-beneficial. However, AcSEC does not believe the cost-benefit argument applies to planned major maintenance deferrals and accruals, as those items and the individual costs associated with them are more readily identifiable.

A54. AcSEC concluded that an entity not applying component accounting at date of adoption should, when replacing a component of PP&E, write off an estimate of the remaining net book value of the replaced component, and that the estimate should be based on the same method and expected useful life previously used to depreciate the total PP&E asset to which the component relates. AcSEC's conclusion is consistent with the ongoing accounting for similar situations as stated in paragraph 38 of this SOP. Inasmuch as the entity chose at time of adoption to continue to depreciate all components of the total PP&E asset over the expected useful life of that asset, AcSEC believes that allowing entities to subsequently recalculate a different expected useful life for components at time of replacement could potentially lead to abuse. For an entity making the choice not to apply retroactive component accounting at transition, AcSEC concluded that the useful life currently utilized for the PP&E must represent the entity's best estimate of all of the components associated with the PP&E.

A55. With respect to the transition provisions for both component accounting and capitalization of overhead charges, some respondents to the exposure draft commented that the SOP should require a cumulative effect adjustment and permit no other alternatives. Those respondents commented that to allow alternatives would result in (a) lack of future comparability among income statements for a single entity and between entities in the same industry, which would be present for an extended period of time due to the long-lived nature of PP&E, and (b) a "double hit" for overhead expensing—current recognition of depreciation expense from previously capitalized overhead as well as expensing of current overhead.

A55A. From a conceptual perspective, AcSEC believes that the retroactive approach for component accounting reflects (and a cumulative effect approach does not reflect) its belief that a change to component accounting is a change in estimate of the expected useful lives of components, which is reflected prospectively under APB Opinion No. 20, *Accounting Changes*. From an implementation standpoint, AcSEC believes that mandating a cumulative effect adjustment would not be practicable with respect to either component accounting or overhead capitalization, as entities may not have the historical information necessary to reasonably estimate a cumulative effect in either case. AcSEC believes that allowing a cumulative effect adjustment as an alternative would result in a lack of future comparability akin to that described in paragraph A55 above, as it would result in three allowable transitional accounting treatments for component accounting and two allowable treatments with respect to overhead capitalization. Finally, AcSEC was concerned that, in view of the potential estimation difficulties noted above, entities might overestimate or underestimate the amount that should be recorded as a cumulative effect adjustment. AcSEC appreciates the concerns expressed by respondents with respect to either requiring or allowing cumulative effect adjustments, but believes that the approach in the ED is reasonable and represents the most practicable approach.

A55B. AcSEC concluded that in order to account prospectively for planned major maintenance activities under the guidance in paragraphs 44 and 45 of this SOP, a company should remove all previously recognized assets and liabilities related to such maintenance activities and record such as a cumulative effect adjustment as of the beginning of the period of adoption.

A56. AcSEC considered three transition alternatives for capitalization versus expensing of costs in the situation in which an entity has a PP&E project in process at the adoption date. The first was to “grandfather in” the accounting method used prior to the adoption and allow the entity to use that method until the end of the project. The second was to require the accounting in the SOP retroactive to the beginning of the project by prescribing that all PP&E *placed in service* after the adoption date be accounted for under the guidance in the SOP. The third was, upon adoption, to require that costs incurred on a project be accounting for prospectively under the guidance in the SOP. AcSEC rejected the first alternative because it believes it would allow entities with projects in progress at date of adoption to apply pre-adoption guidance for potentially a long period of time. AcSEC rejected the second alternative because it would require entities to retroactively estimate and allocate overhead costs, which AcSEC believes may neither be cost-beneficial nor practicable for many entities. Whereas AcSEC recognizes that the third alternative may result in a limited number of PP&E assets having a cost based on a mixture of pre-adoption and post-adoption cost models, AcSEC believes that alternative is reasonable and provides the most practicable means of accounting for PP&E assets in process at adoption.

APPENDIX B

CAPITALIZATION-EXPENSE MATRIX

B1. The following matrix is intended to illustrate the guidance on certain property, plant, and equipment (PP&E)-related costs in paragraphs 15 through 41 of this Statement of Position (SOP). It is intended for summary purposes only and should not be used without further reference to the SOP.

PP&E Project Stages, Sample Activities, and Accounting Guidance Summary

	Preliminary Stage	Preacquisition Stage	Acquisition-or-Construction Stage	In-Service Stage
Time line	Prior to time when acquisition of specific PP&E becomes probable	Acquisition of specific PP&E is probable but has not yet occurred	Acquisition has occurred or construction has commenced but PP&E is not yet substantially complete and ready for its intended use	Subsequent to when PP&E is substantially complete and ready for its intended use
Sample activities	Consideration of alternatives, feasibility studies, activities occurring prior to decision to select specific PP&E	Surveying, zoning, engineering studies, design layouts, traffic studies (these all may also occur in preliminary stage)	Acquisition, construction, or installation of PP&E; engineering work, design work	Replacements, additions to existing PP&E, repairs and maintenance
Accounting for costs directly identifiable with specific PP&E	Expense	Capitalize certain costs	Capitalize certain costs	Capitalize replacements and additions; expense repairs and maintenance; expense net book values of replaced PP&E
Accounting for general and administrative, overhead, and support function costs	Expense	Expense	Expense	Expense

APPENDIX C

EXAMPLES

Example 1—Replacement of component of property, plant, and equipment (PP&E) after adoption of Statement of Position (SOP)

An entity's elevator bank, consisting of 8 elevators, is depreciated on a straight-line basis over its expected useful life of 15 years. The entity has previously applied component accounting to the elevator bank as a whole but not to the individual elevators. The elevator bank has been depreciated for 10 years. The entity ~~spends~~pays an independent third party $20,000 to replace one elevator, which it now determines should be accounted for as a component separate from the elevator bank as a whole. The cost of the new elevator and its installation is $19,000. The cost of removing the previous elevator is $1,000. The entity estimates, through reference to historical accounting records, that it previously capitalized $15,000 for the elevator being replaced. In determining the amount that should be charged to depreciation expense for the replaced elevator, the entity must determine its net book value.

The accumulated depreciation is $10,000 ($15,000 multiplied by 10 years divided by 15 years); therefore, the estimated net book value of the elevator being replaced is $5,000 ($15,000 less $10,000), which is charged to depreciation expense. The entity capitalizes $19,00~~0~~, the cost of the new elevator and its installation. The entity ~~charges to expense~~also capitalizes, as part of the cost of the new elevator, the $1,000 cost to remove the old elevator. Given that the one individual elevator's actual life was less than originally estimated for the bank of elevators, management should consider reevaluating the component accounting level and the expected useful lives of the other seven elevators in the bank and of any similar assets.

Example 2—Replacement and write-off of remaining net book value after adoption of SOP

Prior to the adoption of this SOP, an entity owns a building that is depreciated as a single asset on a straight-line basis over its expected useful life. The cost of the building was $1,000,000. The entity determined the building's expected useful life to be 40 years after considering the useful lives of the building's identifiable parts or portions. The building has been depreciated for 20 years ($500,000 of accumulated depreciation).

At time of adoption, the entity does not elect to apply retroactive component accounting but rather elects to apply the component accounting guidance in this SOP on a prospective basis. A few months after adoption, the entity replaces the roof on the building. ~~The~~Management determines that the new roof represents a separate component and, therefore, should be accounted for separately. The entity estimates the original costs capitalized related to the replaced roof were $200,000. The entity must determine the amount that should be charged to depreciation expense in the current period to reflect the replacement of the old roof.

The company should charge $100,000 to depreciation expense to reflect the replacement of the roof. That amount is calculated as $200,000 estimated original roof cost, less $100,000 of estimated accumulated depreciation (20 years divided by 40-year expected useful life of the building, multiplied by $200,000 estimated original cost of the roof). The entity should not reestimate the original expected life of the replaced roof in performing the calculation. Because the entity did not apply retroactive component accounting at transition, the useful life of the roof is deemed to be that of the building as a whole. Certain costs associated with the new roof (determined in accordance with the guidance in paragraph 37 of this SOP), including costs of removal of the old roof, would be capitalized as a separate component. ~~The costs of removing the old roof should be charged to expense.~~

Example 3—Retroactive component accounting at date of adoption of SOP

On January 1, 1981, an entity placed in service a building with a cost of $1,000,000. The building was depreciated on a straight-line basis using a 40-year composite expected useful life. The entity adopted the SOP effective January 1, 2002, and elected to retroactively apply component accounting at date of adoption. Analysis indicates that the building comprises five components: a roof, an elevator system, a security system, a building shell, and the remainder of the building. The security system is no longer in use at the date of adoption. The entity must determine the proper accounting for accumulated depreciation as part of its retroactive application of component accounting.

The company must estimate the remaining useful life of all components in service at the date of adoption and estimate the original capitalized cost associated with each component. Analysis indicates that the remaining lives of the components in service as of January 1, 2002, are as follows: roof—9 years; elevator system—4 years; building shell—29 years; and "all other"—4 years. Historical records of the company indicate that the original capitalized costs of the components were as follows: roof—$200,000; elevator system—$100,000; security system—$20,000; building shell—$400,000; and "all other"—$280,000. As illustrated below, the pro forma net book value of the components is $122,200 less than the net book value of the entire building at the date of adoption. Paragraph 71(a) of this SOP concludes that the difference resulting from the retroactive calculation of net book value represents a change in expected useful life, which should be accounted for prospectively as a change in estimate. To effect the change in estimate prospectively, only the $122,200 difference is allocated back to the net book values of the components. Future period depreciation expense is based on the expected remaining useful lives of the components.

	Gross Book Value	Accumulated Depreciation	Net Book Value
Pre-adoption			
Building	$1,000,000	$525,000	$475,000

~~**Step 1: Recalculate pro forma net book value based on remaining estimated useful lives of components and actual time in service**~~
Step 1: Recalculate pro forma net book value based on remaining estimated useful lives of components and actual time in service **at date of SOP adoption.**

	Gross Book Value	~~Time~~ Time in Service to Date (yrs)	~~Total~~ Total Expected Useful Life (yrs) **(Note 1)**	Pro forma Accumulated Depreciation	Pro forma Net Book Value
	[A]	[B]	[C]	[D] = (B/C) x A	[E] = A - D
Roof	$ 200,000	21	30	$140,000	$ 60,000
Elevator system	100,000	21	25	84,000	16,000
Security system	20,000	10	10	20,000	0
Building shell	400,000	21	50	168,000	232,000
All other	280,000	21	25	235,200	44,800
	$1,000,000			$647,200	$352,800

Difference between pro forma accumulated depreciation and actual accumulated depreciation:
~~Difference between pro forma accumulated depreciation and actual accumulated depreciation:~~
~~$647,200 - $525,000 = $122,200~~
$647,200 - $525,000 = $122,200

Step 2: Allocation of pro forma difference to all components remaining in service.

~~Pro forma~~ Pro forma Net Book Value	~~Pro forma~~ Pro forma Difference Allocation **(Note 2)**	~~Allocated~~ Allocated Net Book Value
[E]	[F]	[G] = E + F

Roof	$ 60,000	$ 20,782	$ 80,782
Elevator system	16,000	5,542	21,542
Security system	0	0	0
Building shell	232,000	80,358	312,358
All other	44,800	15,518	60,318
	$352,800	$122,200	$475,000

Step 3: Calculation of allocated accumulated depreciation by component.

	~~Pro forma~~ Pro forma Accumulated Depreciation [D]	~~Pro forma~~ Pro forma Difference Allocation [F]	~~Allocated~~ Allocated Accumulated Depreciation [D] - [F]
Roof	$140,000	$ 20,782	$119,218
Elevator system	84,000	5,542	78,458
Security system	20,000	0	20,000
Building shell	168,000	80,358	87,642
All other	235,200	15,518	219,682
	$647,200	$122,200	$525,000

Note 1 Total useful life equals estimated remaining life plus

~~**Note 1**~~ ~~Total useful life equals estimated remaining life plus~~
~~number of years already depreciated.~~
number of years already depreciated.

Note 2 Allocation based on relative pro forma net book values.

~~**Note 2**~~ ~~Allocation based on relative pro forma net book values.~~
~~For example, the $20,782 allocation to the roof is~~
For example, the $20,782 allocation to the roof is
~~calculated as ($60,000/$352,800) multiplied by $122,200.~~
calculated as ($60,000/$352,800) multiplied by $122,200.

Note: The level of component accounting in this example is for illustrative purposes only. An entity may elect to apply

~~**Note:**~~ ~~The level of component accounting in this example is for illustrative purposes only. An entity may elect to apply component accounting on a more detailed level.~~
component accounting on a more detailed level.

Example 4—Probability of acquiring specific PP&E

An entity determines that it is probable that it will build a manufacturing plant that will be used in its operations. The entity acquires options on two parcels of land (one parcel in City X and one parcel in City Y) and currently owns two other vacant parcels in City X. Only one parcel of land ultimately will be used to build the plant. The entity is currently performing market distribution and labor studies to determine the location of the plant among the four alternatives. The entity must determine if it is in the preliminary or preacquisition stage with respect to the manufacturing plant.

The entity is in the preliminary stage with respect to the land on which the manufacturing plant is to be built. The probability determination for purposes of moving from the preliminary stage to the preacquisition stage is applied at the specific PP&E level rather than at the project level. In order to achieve the probability threshold for the land, it must be probable that the entity will acquire a specific parcel of land (or use a specific parcel of existing land) and construct the plant on that land. Because all expenditures in the preliminary stage, with the exception of payments to obtain the options, should be charged to expense as incurred, all of the market distribution and labor studies should be charged to expense as incurred. Payments to obtain the options to acquire PP&E should be capitalized, and the options should subsequently be carried at the lower of cost or fair value less cost to sell.

If it is probable the entity will construct the plant on *some* land site, then costs incurred in connection with designing the plant structure are subject to the preacquisition-stage guidance in this SOP. An example of such a cost would be the cost of architectural drawings of the plant.

Example 5—Component accounting

An airline is repainting the exterior of a jet aircraft it purchased 6 years ago. Because the airplane paint design was unique, the manufacturer had billed the airline separately for the cost of the special paint job. Management recorded the original paint as a separate component of the aircraft and depreciated it over its 5-year expected useful life. The airline must determine the proper accounting for the cost of repainting the aircraft.

Because the painting represents a tangible portion of PP&E that (1) is separately identified as an asset and can be depreciated over its own expected useful life and (2) is expected to provide economic benefit for more than one year, the costs of subsequent painting should be capitalized. The costs of stripping the old paint would be charged to expense, in accordance with paragraph 39 of this SOP. No additional charge to depreciation expense would be required because the old paint was fully depreciated.

If, in this example, the entity did not previously apply component accounting to the cost of the paint, the accounting treatment of the replacement paint may be different. If the entity determines that component accounting for the replacement paint is appropriate in accordance with paragraph 50 of this SOP, it should capitalize the replacement paint as a component, and estimate the remaining net book value of the paint replaced (in accordance with paragraph 53 of this SOP), which would then be charged to depreciation expense. In addition, the entity also should apply component accounting to the paint on its existing jet aircraft and future similar replacement paint projects. If, however, in accordance with paragraph 52 of this SOP, the entity determines that component accounting for the replacement paint is not appropriate because painting represents the normal, recurring, and periodic replacement of a minor item or falls below the entity's reasonable threshold for capitalization, the entire cost of the replacement paint project should be charged to expense in the period incurred. The entity should apply paragraphs 50 through 52 to all of its PP&E assets on a consistent basis.

Example 6—Deferred repairs and maintenance; rehabilitation

An entity owns two similar manufacturing facilities, Facility A and Facility B. During a 5-year period, the entity performs ongoing repairs and maintenance on Facility A, but similar work is not performed on Facility B. After the 5-year period, Facility B is in need of substantial maintenance to regain its commercial viability, and the entity decides to do a rehabilitation to make up for all the work not performed over the 5 years. The rehabilitation will be more expensive than if the entity had performed the ongoing repairs and maintenance to Facility B over the years. The entity will also replace or add certain components to Facility A. The entity must determine the proper accounting for the costs incurred for both facilities during the 5-year period.

For each facility, to the extent components are added or replaced, the components should be capitalized under paragraph 37 of this SOP. The net book values of replaced components should be charged to depreciation expense in accordance with paragraph 38. All other costs should be charged to expense. The guidance in this SOP is not affected by the performance of significant maintenance costs at one time as compared to the performance of normal, ongoing maintenance.

Example 7—Planned major maintenance activities

An entity performs planned major maintenance activities (including replacing piping, repairing and inspecting turbine engines, and cleaning and lubrication of processing equipment) on its refinery every 5 years. The entity must determine the accounting for the costs of the planned major maintenance activity.

The planned major maintenance activity includes repair and maintenance of existing components and replacement of existing components. Costs of replacing piping should be capitalized in accordance with~~paragraph 37 of this SOP, with the exception of removal costs associated with the replacement activities (which should be charged to expense in accordance with paragraph 39).~~paragraphs 37 and 37A of this SOP. Although lubrication of processing equipment is a replacement of lubricant, the activity represents the "normal, recurring, and periodic replacement of minor items" in accordance with paragraph 52, and those costs should be charged to expense as incurred. All other costs (repairing and inspecting turbine engines, and cleaning of processing equipment) also should be charged to expense as incurred in accordance with paragraph 37.

Example 8—Accounting for internal labor costs

An entity is constructing a franchise restaurant. A project superintendent and the chief executive officer spend time working directly on the project. Over the 6-month period of construction, the superintendent, based on project time records, devotes 75 percent of his time (total hours employed) to directly supervising the project. The chief executive officer spends 15 percent of her time (total hours employed) reviewing the construction project budget, giving final approval to site selection, and approving architectural drawings. The entity must determine what portions of the superintendent's and chief executive officer's compensation and related overhead (payroll benefits, rent, other occupancy costs, and so on) qualify for capitalization.

In accordance with paragraph 28(b) of this SOP, 75 percent of the superintendent's payroll and payroll benefits should be capitalized, as project supervision represents an activity that is directly identifiable with the construction process. None of the payroll and payroll benefit-related costs associated with the chief executive officer's time should be capitalized to the project, as executive management represents a support function in accordance with paragraph 29. All overhead and support costs related to both the superintendent and the chief executive officer should be charged to expense in accordance with paragraph 29.

Example 9—Phasing of real estate projects

An entity acquires a 100-acre parcel of land that will be used to build two office buildings, one to be used by the entity as its corporate headquarters and one to be held for rental to independent third parties. The office buildings will be joined by a common parking lot. The entity begins construction of the corporate headquarters and parking lot and will prepare the entire site, but is not immediately starting construction of the rental building. The entity must determine what portion of the property taxes should be capitalized.

In accordance with paragraph 35 of this SOP, because each building will be operated independently, the entity should account for the buildings as two separate projects. The parking lot represents a separate component and should be accounted for as a separate project as well. The property taxes on the land should be allocated between the three projects on the basis of the relative fair value of the parcels of land associated with each of the projects. All of the property taxes incurred for the three projects will qualify for capitalization during the period of site preparation (removal of trees, grading of land, and so on) if site preparation is performed for the entire parcel of land concurrently. After site preparation is complete, the property taxes allocated to the land under which the rental building project will be built should be charged to expense in the period incurred because activities necessary to get that asset ready for its intended use are no longer in progress. Once site preparation is complete, in accordance with paragraph 32, the property taxes allocated to the corporate headquarters and parking lot should be capitalized during the period that activities necessary to get the headquarters and parking lot ready for their intended use are in progress. When activities to prepare the parking lot for its intended use are suspended or are no longer in progress (for example, the parking lot is completed), capitalization of property taxes allocated to the parking lot land should cease.

If some of the 100 acres of land will not be modified for site preparation, but rather were purchased for privacy or other reasons, the property taxes for that portion of the land should be charged to expense as incurred.

APPENDIX D

SAMPLE FINANCIAL STATEMENT FOOTNOTE DISCLOSURES

Accounting Policies

Property, plant, and equipment—Amounts capitalized as property, plant, and equipment are carried at cost. If a component of an asset has an expected useful life that differs from the expected useful life of the total PP&E asset to which it relates and the expected useful life of the component is greater than one year, the Company accounts for the component as a separate asset.

Depreciation—The Company computes depreciation using the straight-line method based on the separate expected useful life of each component.

Repairs and maintenance—The Company includes the following costs in repairs and maintenance expense:

- Wages and fringe benefits of maintenance personnel
- Maintenance and service contracts
- Normal, recurring, and periodic replacement of minor items, including spare parts
- Planned major maintenance

Property, Plant, and Equipment Footnote

Amounts and expected useful lives of PP&E at December 31, 20X2, are as follows:

	Amounts[1]	~~Expected~~ Expected useful lives	Wgtd avg remaining expected useful lives
Land and improvements:			
Land	$1,000,000		
Land improvements	~~200,000~~ 200,000	~~10–15 years~~ 10–15 years	12.7 years
	1,200,000		
Buildings:			
~~Roofs~~	~~200,000~~	~~20–25 years~~	
~~HVAC systems~~	~~100,000~~	~~10 years~~	
Building shell and other	500,000	50 years	35 years
~~Elevators~~	~~100,000~~	~~7~~	
Roofs	100,000	20–25 years	6.1 years
Leasehold improvements	~~200,000~~ 100,000 (a)		
~~Building shell and other~~	~~700,000~~	~~50 years~~	
	~~1,300,000~~ 700,000		
Machinery and equipment:			
~~Vehicles~~	~~40,000~~	~~5–7~~	
Manufacturing equipment	1,000,000	15–25 years	22.8 years
Computer hardware and software	~~80,000~~ 100,000	~~3–7~~ 3–7 years	1.9 years
~~Manufacturing equipment~~	~~350,000~~	~~15–25 years~~	
~~Other~~	~~20,000~~	~~5–10 years~~	
	~~490,000~~		
Vehicles and other equipment	100,000	5–10 years	7.4 years
	1,200,000		
Total land and depreciable PP&E	~~2,990,000~~ 3,100,000		
Less: accumulated depreciation	~~(790,000)~~ (900,000)		
Net land and depreciable PP&E	2,200,000		
Construction in progress:			
~~Capitalized preacquisition costs~~	~~80,000~~		
Warehouse	~~720,000~~ 800,000		
	~~800,000~~		
~~Total net PP&E~~			
Total net PP&E	$3,000,000		

[1] To simplify the illustration, comparative prior-year amounts are not shown.

Depreciation expense for the years ended December 31, 20X1 and 20X2, was $200,000 and $180,000, respectively. Repairs and maintenance expense for the years ended December 31, 20X1 and 20X2, was $500,000 and $325,000, respectively.

(a) Shorter of useful life or related lease term

APPENDIX E

THE GROUP-LIFE METHOD OF ACCOUNTING

As discussed in paragraph 56 of this SOP, the group-life method of accounting (also often referred to as “mass asset” accounting) may be applied in place of component accounting, under certain conditions, to large numbers of PP&E assets homogeneous as to physical characteristics, use, expected useful life, and dispersion of useful lives around the average. For some kinds of PP&E, such as utility poles, railroad ties, rails, wire, and cable, it is typically not practicable to measure and track each individual item. In applying the group-life method, assets are grouped such that homogeneous units that are used and operated in the same manner, and are subject to the same influences causing retirements, have the same expected useful life. After the asset group has been identified, a depreciation life study is conducted to determine factors such as the average useful life of all of the units included in the group and retirement patterns. The group-life method differs primarily from component accounting in that (a) an accumulated depreciation account is maintained for the group of assets and does not relate to any particular asset within the group, and (b) an asset within the group is assumed to be fully depreciated upon normal retirement or disposal. Accordingly, the full original cost of the retired asset is charged to the related accumulated depreciation account and proceeds from salvage, if any, are credited to the accumulated depreciation account. Normal retirements, therefore, do not impact current period earnings.

GLOSSARY

component. A tangible part or portion of PP&E that (1) can be separately identified as an asset and depreciated or amortized over its own separate expected useful life and (2) is expected to provide economic benefit for more than one year.

demolition costs. Costs, net of recoveries (such as the sale of scrap metal), incurred to demolish and remove existing PP&E. Demolition costs do not include the net book value of existing PP&E that is to be abandoned and ~~demolished.~~[1]
demolished. They do not include costs of an asset retirement obligation under the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*. They do not include costs of disposal under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

expected useful life. Period of time over which an item of PP&E is expected to provide economic benefits to an entity. In the determination of expected useful life, it is presumed that an entity will perform normal, ongoing, or periodic maintenance activities on that PP&E. For leased PP&E, expected useful life should be determined in accordance with FASB Statement No. 13, *Accounting for Leases*.

ground rentals. Contractual payments due under an operating lease for the use of land.

group-life method of accounting. A method of accounting for a group of homogeneous PP&E assets under which (a) depreciation is based on the application of a single depreciation rate to the total cost of all PP&E included in the group, despite differences in service life of individual items of PP&E, (b) the full original cost, less any salvage realized, of a retired item of PP&E in the group is charged to accumulated depreciation regardless of the age of the item, and (c) no gain or loss is recognized on the retirement of individual items in the group. See also appendix E of this SOP.

homogeneous. Having the following characteristics: (a) fungibility, that is, homogeneous PP&E assets can be readily substituted for one another in an entity's operations, (b) possessing the same expected useful life when new, and (c) if acquired around the same time, having approximately the same unit cost. Examples of homogeneous PP&E assets include utility poles; railroad ties; electric transmission lines; and pipe sections in a gas pipeline. Examples of non-homogeneous PP&E assets include a group of both pickup trucks and tractor trailers; apartment buildings; and manufacturing plants.

~~[1] The Financial Accounting Standards Board (FASB) has issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting for the Impairment or Disposal of Long-Lived Assets and for Obligations Associated with Disposal Activities*, that addresses the issue of abandonment. That Statement would supersede FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*. Readers should be alert to any final pronouncement.~~

incremental direct costs. Costs of a PP&E project that would not be incurred but for that project. Examples include purchase price; construction materials; external consulting costs; travel costs incurred in connection with activities relating to the acquisition, construction, or installation of PP&E; rental costs of equipment used in construction or installation of PP&E; equipment installation costs by a contractor; sales and use taxes on materials or services purchased; import duties; and freight and transportation-related insurance (for example, a rider resulting in a premium increase).

independent third party.[2] A third party that generally possesses the following characteristics:

- Is not an employee of the reporting entity
- Is not receiving employee benefits from the reporting entity
- Is not under the control of the reporting entity (Paragraph 24(b) of FASB Statement No. 57, *Related Party Disclosures*, defines control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract, or otherwise.")
- Generally, provides similar services to other entities unrelated to the reporting entity, and there would not be an agreement between the reporting entity and the party that precludes the party from performing similar services to other entities.

If the reporting entity has an ownership or equity interest in a third party, that would generally indicate a relationship that would not qualify as an independent third party; however, a nominal passive investment from the standpoint of both the reporting entity and the third party probably would not affect the third party's independence.

liquidated damages. Contractual payments made by a seller to a buyer of PP&E for nondelivery or noncompletion of PP&E construction by a stated completion date. The amount is specified in advance by contract—for example, a stated amount per day of delay—rather than a computation of actual losses of the buyer caused by the delay. Liquidated damages are negotiated to represent compensation for a reasonable estimate of the buyer's costs associated with a delay and are specified in advance in order to eliminate the need for possibly contentious after-the-fact negotiations about actual costs incurred.

planned major maintenance activities. Also referred to as "overhauls," "turnarounds," and "refurbishments." These are other than routine activities that an entity considers necessary to perform on a recurring basis to maintain PP&E in operating condition. Examples include shutting down an oil refinery at regular intervals to overhaul the equipment, or taking an airplane engine out of service at regular intervals to perform an overhaul.

[2] Based on the Questions and Answers relating to paragraphs 6, 7, and 10 in the FASB Staff Implementation Guide *A Guide to Implementation of Statement 91 on Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases*.

property, plant, and equipment (PP&E). Tangible assets that (1) are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and (2) are expected to provide economic benefit to an entity for more than one year. PP&E is comprised of one or more components.

removal costs. Costs to remove PP&E, including costs necessary to disassemble a component to gain access to ~~a subcomponent to be replaced.~~another component to be replaced. Removal costs do not include costs of an asset retirement obligation under the scope of FASB Statement No. 143 or costs of disposal under FASB Statement No. 144.

substantially complete and ready for its intended use. A characterization of PP&E that is demonstrated by completion of all major acquisition, construction, and installation activities (as distinguished from activities such as routine maintenance and cleanup) or by the beginning of related revenue recognition, if sooner.