Grant Thornton

Technical Accounting Alert

Pre-opening lease expenses

Introduction

The purpose of this alert is to provide guidance for accounting for "pre-opening" operating lease expenses.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 16 Property, plant and equipment	AASB 116 Property, plant and equipment
IAS 17 Leases	AASB 117 Leases
IAS 23 Borrowing costs	AASB 123 Borrowing costs

Overview

It is common in some industries for an entity to lease operating premises and then spend a period of time preparing the premises for their intended use. For example, a retailer might enter into a property lease and then spend some months adapting and fitting the property before opening a new store. During this "pre-opening" period, various improvements are made and fixtures installed which may qualify to be capitalised as PP&E (if the criteria in IAS 16.7 etc are met). Issues then arise as to:

- whether or not operating lease expenses incurred during the pre-opening period are part of the cost of the PP&E; and
- whether or not operating lease expenses should be recognised during the pre-opening period in accordance with IAS 17.33 (given that deferring expense recognition until the start of operations might be argued to be "more representative of the time pattern of the user's benefit" than straight-line recognition).

Operating leases

It is sometimes argued that operating lease expenses incurred during the pre-opening period are part of the cost of the PP&E installed in the leased property (ie the improvements and fittings). IAS 16.16 (b) requires that "the cost of an item of PP&E comprises... any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management". However, in our view operating lease expenses are **not** "directly attributable" to the installed PP&E. Rather, the lease expenses are attributable to the leased property (which, in an operating lease, is not regarded as an asset of the lessee).

Operating lease expenses incurred during the pre-opening period are more explicitly dealt with in IAS 16.19. IAS 16.19 does not permit capitalization of costs of opening a new facility, costs of conducting a business in a new location or administrative and general overhead costs (and other similar items). In other words, start-up costs are neither assets in themselves, nor a component of the cost of other PP&E.

Examples of costs that are directly attributable to the cost of an item of PP&E include:

- costs of employee benefits arising from the construction or acquisition of an item of PP&E;
- costs of site preparation;
- initial delivery and handling costs;
- costs of testing whether the asset is functioning properly; and
- professional fees (IAS 16.17).

We also consider that the user (ie the lessee) derives benefits from leased property as soon as it has access to that property. The lessee's right to adapt and prepare the property for its own operations is a benefit. It is therefore inappropriate to defer or suspend recognition of lease expenses during the pre-opening period.

Pre-opening operating lease expenses are start-up costs and should therefore be expensed as incurred. They are not part of the cost of an item of property, plant and equipment (PP&E) (IAS 16.19).

Operating lease expenses should be recognised on a straight-line basis unless another method is more representative of the time pattern of the user's benefit (IAS 17.33). The user derives benefits as soon as it has access to the leased property. It is therefore inappropriate to use an expense recognition method that defers or suspends expense recognition during the pre-opening period.

Finance lease

If property is held under a finance lease, the related finance charges may be eligible for capitalisation in accordance with IAS 23. IAS 23 requires capitalisation of eligible borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset when the conditions are met. Eligible borrowing costs include finance charges in respect of finance leases (IAS 23.6(d)).

The leased property might be a qualifying asset if it requires a substantial period of time to make it ready for its intended use. However, IAS 23 permits capitalisation only whilst construction, development or other necessary activities are in progress (IAS 23.22). We therefore consider that a building held under a finance lease is a qualifying asset only whilst there is significant activity in relation to the building itself (eg structural work). A leased building that is complete, but requires minor modifications (such as decorating), is unlikely to be a qualifying asset (IAS 23.23).

The reason that finance lease interest costs might be eligible for capitalisation, whilst operating lease expenses are not, is that in finance lease accounting the leased property is recognised as an asset of the lessee. The "qualifying asset" is the leased asset. By contrast, in an operating lease, the leased property is not an asset of the lessee and any improvements or fittings are therefore separate assets.

Further information

For further information on any of the information included in this TA Alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au