



Olympic Systems

Accounting for Leasehold Improvements

Cost Accounting Fundamentals Series
by Thomas Goodspeed

Project Cost by Olympic Systems for Microsoft Dynamics GP



PROJECT COST BY OLYMPIC SYSTEMS, INC.

Accounting for Leasehold Improvements

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About Project Cost

Project Cost is a comprehensive project cost accounting system for Microsoft Dynamics - GP. Project Cost is composed of a series of modules and browser based web applications that focus on managing, recording and reporting of Project Budgets, PO Commitments, and Project Cost & Revenues.

Our goal was to build a fully integrated cost accounting extension to that would be Easy to Use, Easy to Understand and Easy to Manage.

Project Cost integrates with System Manager and extends functionality to the following modules:

General Ledger	Payables Management	Receivable Management	Payroll
Inventory Control	Sales Order Processing	Purchase Order Processing	SmartLists

Accuracy: Project Cost allows users to efficiently and accurately charge costs to the appropriate Project and Task. Users do not need to understand account coding requirements, by selecting the correct combination of Project and Task – the proper account coding is achieved.

Ease of Use: Project Cost extends the standard Dynamics GP accounting transaction windows making assignment of Project and Task codes to all or portions of an accounting transaction both efficient and accurate.

Fast Deployment: Deploying Project Cost for Leasehold Improvements can be completed in as little as 8 hours.

Collect Cost by Asset Depreciation Type: Project Cost can collect cost details and quickly summarize cost by asset depreciation type for easy capitalization posting for complex projects.

Consistency: Project Cost supports cost accounting guidelines that require that cost based contracts consistently use identical costing techniques and policies across bid and proposal documents and invoices for products and services.

Reduced Cost: Project Cost reduces costs with lower installation and training costs, fewer keystrokes, and fewer errors and corrections.

Reconciliation of Sub-Ledgers: Project Cost provides automated reconciliation between the General Ledger and the Project Cost Transaction Sub-Ledger.

Perfect Audit Trail: Project Cost provides a perfect audit trail between each Dynamics GP transaction, each GL transaction, and the associated Project Cost transaction. Project Cost audit tools records any changes made to a project transaction, including those that are eventually deleted. This makes the review and auditing of project transactions fast and easy.

Introduction – Accounting for Leasehold Improvements

Often a company will make the decision to make improvements to a leased facility in order to improve usability or operations of the facility. This type of project could be as simple as putting some paint on the walls or more complex improvements could include changing of floor plans, adding room partitions, new electrical or security systems... the list could go on and on.

Accounting for Leasehold Improvements is similar to accounting for Self Constructed Assets.

Leasehold Improvements (with a few exceptions) are generally capitalized as an intangible long term asset and then amortized as a period expense. This permits the company to spread the expense out over a specific period of time and thereby reducing the negative effect on revenue.

The reasons for undertaking Leasehold Improvements can be complex and varied but once the decision is made, the company takes on the responsibility of tracking progress of the project and accumulation of the cost associated with the construction of the new improvements.

The purpose of this paper is to provide a discussion of fundamental procedures and practices related to Accounting for Leasehold Improvements. The information contained in this whitepaper has been gathered from multiple sources, text books, seminars, correspondence and other open source resources.

The information presented here is intended to be used as a topic resource and guidance to assist organizations with their review their current accounting procedures for tracking Leasehold Improvements.

This paper will discuss:

1. Leasehold Improvements – Terms & Definitions
2. How do Leasehold Improvements differ from Self-Constructed Assets?
3. What is CIP?
4. What qualifies as a Cost when building Leasehold Improvements?
5. When to Capitalize the Leasehold Improvement?
6. Amortization of the Leasehold Improvement
7. 9 Basic Steps to Track 'Leasehold Improvements'

Note: This paper does not address the following topics:

1. *Improvements made in lieu of rent – which are normally expensed in the period incurred.*
2. *Tenant Improvements which are changes made to the interior of a commercial or industrial proper by its owner to accommodate the needs of a tenant such as paint, wall coverings, partitions, and such... These costs are often paid for by the property owner however, they can be negotiated to be part of the lease.*

For additional information on these topics please consult with your Audit Firm or contact our office

Leasehold Improvements – Terms & Definitions

Leasehold:

Leasehold is a contractual agreement between a Lessor and a Lessee that grants specific rights to use to the lessee of a property, owned by the lessor, for a specific period of time; in return the Lessee agrees to make regular payments (rent) for these rights.

Leasehold Improvements:

Leasehold improvements are enhancements made by the lessee to a leased facility in order to improve usability or functional operation of the facility.

Examples of costs that would normally be considered as leasehold improvements include:

- Interior partitions made up of drywall, glass and metal
- Miscellaneous millwork, carpentry, lumber, doors and paint
- Restroom accessories
- Electric lighting fixtures
- Interior floor finishing, including carpet, vinyl and tile
- Security systems – fire & access security

Long-term leases normally hold that the lessee has the right to use the property and its improvements during the life of the lease. If a lessee makes any improvement to a property the ownership of these improvements will revert to the lessor at the end of the life of the lease and thus Leasehold Improvements do not have any residual value after the expiration of the lease.

The cost of these improvements should be charged (or capitalized) to the Leasehold Improvements account and amortized those cost as operating expenses either over the remaining life of the lease or the useful life of the asset whichever one is shorter.

Leasehold Improvements - are Long-Term Intangible Assets that are tracked temporarily during construction under a special asset category called Construction- In-Progress (CIP).

Long-Term Assets or Fixed Assets as a general category are defined by the nature of their longevity – these are assets that will be used by the company over several years.

Examples of Long-Term Assets include:

- Land
- Buildings
- Construction In Progress (CIP)
- Production Equipment
- Office Furniture
 - Accumulated Depreciation (Contra Account)
- Leasehold Improvements
 - Accumulated Amortization (Contra Account)

Construction-In-Progress assets, like Land, are treated differently than other Long-Term assets – the most prominent difference is that these two asset categories do not record depreciation or amortization.

How do Leasehold Improvements Differ from Self-Constructed Assets?

Self-Constructed Assets normally have the following basic attributes:

1. The Cost of the Asset is built up from several cost events
2. The 'In Service Date' is established at the end of the build which could take weeks, months or even years.
3. By its nature will require some amount of time and work to build and placed in service.
4. An Overall Project such as building a new break room – may result in creation of several asset depreciation types.
5. Most assets will have a residual value. Depreciation is calculated based on the accumulated cost of the asset less the residual value.

Leasehold Improvements have many of the same attributes:

1. The Cost of the Asset is built up from several cost events
2. The 'In Service Date' is established at the end of the build which could take weeks, months or even years.
3. By its nature will require some amount of time and work to build and placed in service.
4. Are amortized over the remaining life of the lease or the estimated useful life of the improvement whichever is shorter.
5. Have no residual value and become the property of the lessor when the lease term expires. At the end of the lease the total cost of the Leasehold Improvement will have been amortized.

What is Construction-In-Progress (CIP)?

Generally, Construction-In-Progress (CIP) is an account that is used to track the cost associated with the construction of either Self-Constructed Assets or Leasehold Improvement projects. This is a Long-Term asset account however; it is used as a temporary storage account and does not have any depreciation or amortization associated with the account value.

When the build out is complete, the value is moved from the CIP account and 'Booked' as a traditional Fixed Asset in the case of Self-Constructed Assets or charged to the Leasehold Improvements account

A well structured Chart of Accounts (COA) provides accounting professionals and auditors with the ability to quickly and easily navigate through an organization's financial data.

Below is a chart that represents a basic organization structure of the Balance Sheet Chart of Accounts. Notice the highlighted Current Assets and Long-Term Assets, Construction in Progress, and Leasehold Improvements.

	Account Category	Natural Account Range
B a l a n c e S h e e t	Current Assets	1000 - 1699
	Cash AR Inventroy	1000 - 1499
	Work In Progress	1500 - 1599
	Other Current Assets	1600 - 1699
	Long-Term - Fixed Assets	1700 - 1899
	Land	1700 - 1710
	Buildings	1720 - 1729
	Production Equipment	1730 - 1739
	Office Equipment	1740 - 1749
	Accumulated Depreciation	1750 - 1759
	Construction In Progress	1760 - 1769
	Leasehold Improvements	1770 - 1779
	Accumulated Amortization	1780 - 1789
	Other Assets	1900 - 1999
	Current Liabilities	2000 - 2799
	Deferred Revenue	2700 - 2799
	Long Term Liabilities	2800 - 2999
Equity	3000 - 3999	

What Qualifies as a Cost When Building Leasehold Improvements?

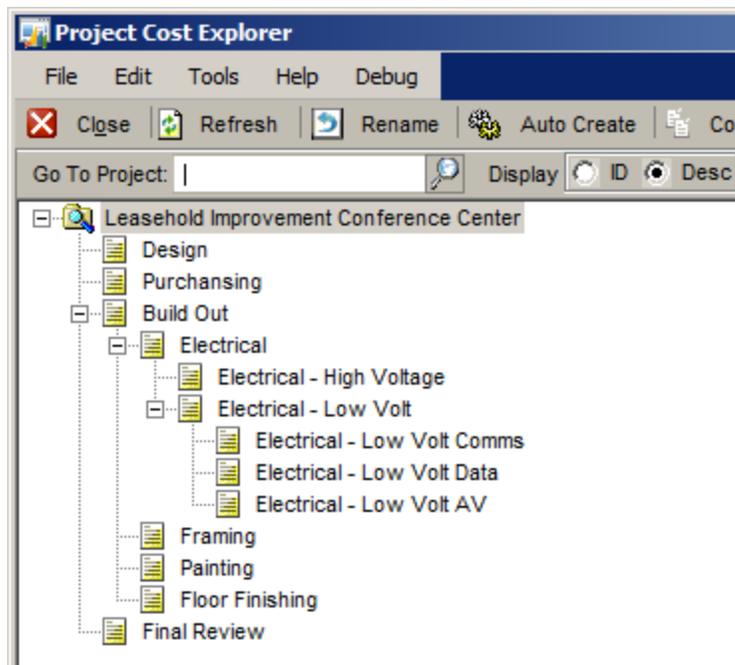
When constructing an asset for internal use it is important to have an organized methodology for keeping track of all the cost incurred for the construction. Project Cost by Olympic Systems is a great tool to assist with the tracking of cost associated with a Self-Constructed Asset.

In order to better explain this topic we will examine the hypothetical **Acme Manufacturing Company**.

Acme signs a 5 year lease on a new sales office building. Acme needs to update the building to include new Conference Center facilities in order to improve usability.

Acme will build out the new conference facilities performing some of the work in house while contracting the remaining work on the project.

Below is the Work-Breakdown-Structure (WBS) for this **Conference Center** project:



Notice that there are multiple activities that need to be completed to build this new asset.

Some activities may be dependent on other steps being completed before that activity can be started, while others are independent.

For example one would not want to start the Painting until after the Framing was complete but Purchasing activities could take place anytime after Design phase and up to the Final Review.

When setting up a new project for tracking the construction of the new asset, we will need to consider all costs that are related to the construction. These cost falls into 2 general categories: Direct Cost and Indirect Cost

Direct Cost - Defined

Direct Costs are cost that can be easily and conveniently traced to a particular cost objective.

Direct Purchase or Material Costs are all purchases and/or materials that become an integral part of the finished asset and can be tracked in an 'Economically Feasible' way.

'**Direct Labor Costs**' are defined as labor expenses directly attributable to the construction of the new asset that can be tracked in an 'Economically Feasible' way.

Often managers will construe **Direct Labor Cost** as simply the employee's hourly rate and use this as a standard cost. This method however, does not provide a complete picture of labor cost nor does it provide managers with the most accurate tools to judge performance and control cost.

To measure **Direct Labor Cost**, you should consider **all** direct labor cost expenditures, not just a worker's salary or wages.

Labor Cost can be grouped into two major groupings:

Direct Salaries or Wages

- Wages (Regular, OT, Vacation, Sick Leave, Holiday, Jury Duty)

Direct Fringe Benefit Cost *(Some organizations will handle fringe as indirect labor costs)*

- Employer Paid Taxes (FUTA, SUTA, FICA, Medicare, Worker's Compensation)
- Employer Paid Benefits (Health Insurance, Contributions to Pension Plans, Tuition, Training Expenses, Bonuses)

Indirect Cost - Defined

Indirect Costs are costs that are not easily and conveniently traced to a particular cost objective.

Indirect costs charged to a Self-Constructed Asset can be controversial – it is recommended that these cost be reviewed with your auditing firm in order to assure that they are being applied using a consistent methodology. General & Administrative (G&A) cost along with other period cost should normally be excluded from being indirect cost applied to Self Constructed Assets.

Indirect Material Costs are defined as expenses incurred for common or joint objectives and not readily identifiable to a specific objective. These expenses could include items like lubricants, glue, nails or other supplies used in the building process.

Indirect Labor Costs are defined as labor expenses incurred for common or joint objectives and not readily identifiable to a specific objective. These expenses should exclude costs associated with supervision, training, or facilities unless they are distinctly required for the construction of the asset.

Indirect Overhead Expense are all production cost incurred by the company for while the asset is under construction except for Material and Labor. Examples may include rents (for self-constructed assets), taxes, insurance, and utilities. Depreciation Expense for any Equipment used in the production of the new asset can also be applied as an Indirect Overhead Expense.

Indirect Interest Expense is the amount of interest expense incurred by the company while the asset is under construction. Interest expense is computed by multiplying the interest rate times the average accumulated cost for each accounting period. Interest Expense cannot exceed the total interest paid by the company in each accounting period. (FAS34)

Leasehold Improvements -Transactional Examples

Keeping with our example of building a High-Speed Packing Station, we will follow the accounting transactions through the construction process.

DIRECT LABOR COST- DESIGN PHASE

In April, the Acme Manufacturing Company starts the design work on this project. Design Engineers draw up the blue prints for the construction of the new Conference Center along with a budget for parts, supplies, direct labor and contract services. Total hours of labor are 35 hours at a 'Standard Cost' rate of 79.97 per hour for a total of \$2,798.95.

Description	Calculation Method	Annual Cost	Hours	Labor Rate
Direct Labor				
Amount Employee Views as Wages or Salary				
Can be Characterized as an Hourly Rate				
May Include Shift or Overtime Premium	Hours x Rate	\$118,040	2,080	\$56.75
Direct Taxes				
Fica, Futa, L&I, SUTA, etc.	Varies 12 & 16%	\$18,886	2,080	\$65.83
Direct Benefits				
Paid or Accrued by Employer for Employee Benefit				
Employer Funded Retirement		\$2,500		
Health Insurance		\$5,953		
Union Vacation & Sick Leave Pay	2 weeks of each	Included	-80	
Holidays	9 days per year	Included	-72	
Car Allowance		\$4,800		
Bonus Pool		\$4,000		
Direct Costing Std Labor Rate		\$154,179	1,928	\$79.97

Project Cost would post an entry something like this to account for the Direct Labor:

Account Title	Debit	Credit
Construction in Progress	\$ 2,798.95	
Design Department Labor Expense Offset		\$ 2,798.95

DIRECT PURCHASE & MATERIAL COST- PURCHASING PHASE

In May, the Acme Manufacturing Company starts purchasing materials for this project. Purchase Orders are issued, materials are received and the vendors are paid.

Total Purchases amount to \$18,528.50.

Project Cost would post an entry something like this to account for the Direct Purchase & Material

Account Title	Debit	Credit
Construction in Progress	\$ 18,528.50	
Accounts Payable		\$ 18,528.50

DIRECT LABOR COST- BUILD OUT PHASE

In June, the Acme Manufacturing Company starts the Build Out of the Conference Center work continues thru October.

Total hours of labor are 925 hours and in this case there are multiple trades performing the work for a total of \$42,910.75.

Project Cost would post an entry something like this to account for the Direct Labor.

Account Title	Debit	Credit
Construction in Progress	\$ 42,910.75	
Engineering Department Labor Expense Offset		\$ 8,396.85
Electrical Department Labor Expense Offset		\$ 12,487.03
Machine Shop Department Labor Expense Offset		\$ 22,026.87

DIRECT SUB-CONTRACT – FINAL REVIEW & CONSTRUCTION PHASE

In November, the Acme Manufacturing Company hires an outside firm to oversee the Final Review and Finish Construction of the Conference Center. The Conference Center project is completed in December.

Total costs of these services are \$12,275.00.

Project Cost would post an entry something like this to account for the Direct Sub-Contract expenses.

Account Title	Debit	Credit
Construction in Progress	\$ 12,275.00	
Accounts Payable		\$ 12,275.00

IN-DIRECT OVERHEAD COST

Each period the Acme Manufacturing Company would determine the amount of Overhead Cost to be charged to the Project. Reasons and Methods for determining overhead vary widely.

[Consult with your Audit Firm for advice on Overhead Cost Capitalization.](#)

For this presentation we will assume the following cost: Material Overhead Expense \$875.29, Depreciation Expense \$1,520.00 (Note: this a portion of the Depreciation Expense on Plant & Equipment used in the construction of the asset), and Electricity Expense of \$600.00

Project Cost would post an entry something like this to account for the Indirect Overhead Cost – Note an Overhead posting should occur each month of the asset build – for ease of presentation we are summarizing the Overhead cost.

Account Title	Debit	Credit
Construction in Progress	\$ 2,995.29	
Accumulated Depreciation		\$ 1,520.00
Accrued Expense - Utilities		\$ 600.00
Material Overhead Applied		\$ 875.29

IN-DIRECT INTEREST EXPENSE

Self-Constructed Assets may qualify for Interest Capitalization as part of the Historical Cost of asset. Interest capitalization is required for those assets if its effect, compared with the effect of expensing interest, is material. If the net effect is not material, interest capitalization is not required.

“The interest cost eligible for capitalization shall be the interest cost recognized on borrowings and other obligations. The amount capitalized is to be an allocation of the interest cost incurred during the period required to complete the asset. The interest rate for capitalization purposes is to be based on the rates on the enterprise's outstanding borrowings.” (FAS34)

Consult with your Audit Firm for advice on Interest Capitalization.

For this presentation we will assume the following a total weighted average calculation with an interest rate of 5.25% resulting in \$1843.46 in interest expense. (Note that the Period Overhead would normally have a different value each month – for ease of presentation we display the Overhead distributed straight line over the life of the build.)

Month	Period Charges	Period Overhead	Period Addition to CIP	Capitalization Period	Weighted Average	Rate	Interest Expense
April	\$ 2,798.95	\$ 332.81	\$ 3,131.76	9/12 Months	\$ 2,348.82	5.25%	\$ 123.31
May	\$ 18,528.50	\$ 332.81	\$ 18,861.31	8/12 Months	\$ 12,574.21	5.25%	\$ 660.15
June	\$ 8,582.15	\$ 332.81	\$ 8,914.96	7/12 Months	\$ 5,200.39	5.25%	\$ 273.02
July	\$ 8,582.15	\$ 332.81	\$ 8,914.96	6/12 Months	\$ 4,457.48	5.25%	\$ 234.02
August	\$ 8,582.15	\$ 332.81	\$ 8,914.96	5/12 Months	\$ 3,714.57	5.25%	\$ 195.01
September	\$ 8,582.15	\$ 332.81	\$ 8,914.96	4/12 Months	\$ 2,971.65	5.25%	\$ 156.01
October	\$ 8,582.15	\$ 332.81	\$ 8,914.96	3/12 Months	\$ 2,228.74	5.25%	\$ 117.01
November	\$ 6,137.50	\$ 332.81	\$ 6,470.31	2/12 Months	\$ 1,078.39	5.25%	\$ 56.62
December	\$ 6,137.50	\$ 332.81	\$ 6,470.31	1/12 Months	\$ 539.19	5.25%	\$ 28.31
Totals	\$ 76,513.20	\$ 2,995.29	\$ 79,508.49				\$ 1,843.46

Project Cost would post an entry something like this to account for the Indirect Interest Expense.

Account Title	Debit	Credit
Construction in Progress	\$ 1,843.46	
Interest Expense		\$ 1,843.46

When to Capitalize the Leasehold Improvement?

Construction-In-Progress (CIP) should be capitalized as soon as it is ready to be put in service. This would be the date the construction is complete and not the actual date it goes into service. At this point the total value of the cost associated with this Leasehold Improvement is moved from Construction in Progress to the Leasehold Improvements account.

In our example the construction period was 9 months out of a 60 month lease. The Capitalization period would be spread over the remaining 51 months of the lease.

Project Cost would post an entry something like this to account for the transfer of the Construction in Progress to the Fixed Asset account.

Account Title	Debit	Credit
Leasehold Improvements	\$ 81,351.95	
Construction in Progress		\$ 81,351.95

Amortization of the Leasehold Improvement

In our example the construction period was 9 months out of a 60 month lease. The value of the Leasehold Improvement will be amortized over the remaining 51 months of the lease.

Value of Leasehold Improvement	\$81,351.95
Capitalization Period	51 Months
Monthly Amortization Expense (50 months)	\$1,595.14
Monthly Amortization Expense (final month)	\$1,594.95

Post an entry something like this to account for the Monthly Amortization Expense.

Account Title	Debit	Credit
Amortization Expense	\$ 1,595.14	
Accumulated Amortization - Leasehold Improvements		\$ 1,595.14

9 Basic Steps for Accounting for Leasehold Improvements

1. Determine CIP account to be used to track the cost of the improvements.
2. Build a unique Project to track the construction of this build out.
3. Collect purchases and other direct cost associated with the construction.
4. Collect labor cost associated with the construction.
5. Allocate Overhead cost associated with the construction.
6. Allocate Interest Expenses associated with the construction.
7. Close the Project to stop accumulating cost as soon as the asset is ready to be put in service.
8. Capitalize the accumulated cost – transfer the cost from the CIP account to Leasehold Improvements account.
9. Amortize the accumulated cost of the Leasehold Improvement.

Other References

[Summary of FAS34 Capitalization of Interest Cost](#)

[Summary of FAS58 Capitalization of Interest Cost...Equity Method](#)

[IRS Publication 551 Basis of Assets - Uniform Capitalization Rules](#)

[IRS – Brief Overview of Depreciation](#)

[IRS – PUB 946 How to Depreciate Property – Section 179](#)

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