Republic of the Philippines
Professional Regulation Commission
Manila

PROFESSIONAL REGULATORY BOARD OF ACCOUNTANCY
Resolution No. 17
Series of 2018

WHEREAS, the Financial Reporting Standards Council (FRSC) has approved and submitted hereunder pronouncements to the Board for approval;

1. PIC Q&A No. 2017-02 PAS 2 *and* PAS 16- *Capitalization of operating lease cost as part of construction costs of a building.*
2. PIC Q&A No. 2017-03 PAS 28 – *Elimination of profits and losses resulting from transactions between associates and/or joint ventures.*
3. PIC Q&A No. 2017-06 PAS 2, 16 and 40 – *Accounting for Collector's Items*

WHEREAS, after study and review of the provisions of the above-stated pronouncements as adopted by the FRSC, the Board finds them to be well-taken and instructive for compliance by practicing Certified Public Accountants;

WHEREFORE, the Board **RESOLVES**, as it is hereby **RESOLVED,** to adopt the above-stated pronouncements as part of the Philippine Accounting Standards.

RESOLVED FURTHER, that this Resolution and the above-stated pronouncements shall take effect after fifteen (15) days following its full and complete publication in the Official Gazette or in any newspaper of general circulation in the Philippines.

Done in the City of Manila, this 15th day of February, 2018.

JOEL L. TAN-TORRES
Chairman

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Vice-Chairperson

GERARD B. SANVICTORES
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Chief
Secretariat to the Professional Regulatory Boards

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Chairman

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JOSE Y. CUETO, JR.
Commissioner

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DATE OF PUBLICATION IN THE OFFICIAL GAZETTE : JUNE 11, 2018
DATE OF EFFECTIVITY: JUNE 27, 2018

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

Q&A No. 2017-02

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

Issue

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

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

Fact Pattern

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

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

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

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

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

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

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

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

Scenario 3 – building is leased and leasehold improvements are made

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

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

Consensus and Basis for Consensus

Scenario 1

View 1: Capitalize as part of construction costs

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

Paragraph 10 of PAS 2 states:

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

Paragraph 15 of PAS 2 states:

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

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

View 2: Expense as incurred

The operating lease expenses are for the right to control the use of the leased asset (i.e., the land). As there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period, an entity recognizes the operating lease costs as an expense. That is, because the lease payments are not incremental, and must be paid regardless of whether the building is constructed, they cannot be a direct cost of the asset.

Scenario 2

View 1: Capitalize as part of construction costs

Paragraph 22 of PAS 16 states:

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

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

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

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

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

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

View 2: Expense as incurred

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

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

Scenario 3

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

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

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

Effective Date

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

Date approved by PIC: June 28, 2017

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Date approved by FRSC: DEC 13 2017

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

Q&A No. 2017-03

PAS 28 - Elimination of profits and losses resulting from transactions between associates and/or joint ventures

Issue

Does the investor eliminate transactions between associates and/or joint ventures when the investor accounts for these associates and/or joint ventures using the equity method?

Fact Pattern

Entity H has the following interests in associates A and B:

Interest in A – 25%

Interest in B – 30%

During the reporting period, Entity A sold inventory to Entity B, all of which remains on Entity B's statement of financial position at the end of the reporting period.

Cost of inventory for A – ₱1,000,000

Proceeds from sale by A – ₱1,200,000

Consensus

The unrealized profit arising from the transaction between associates and/ or joint ventures is eliminated to the extent of the investor's interests in the associates and/or joint venture.

In the fact pattern above, Entity H eliminates ₱15,000 (i.e., 25% × 30% × ₱200,000) as its share of the profits that is unrealized.

Basis for Consensus

Paragraph 28 of PAS 28, *Investment in Associates and Joint Ventures*, states:

"Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognized in the entity's financial statements only to the extent of the unrelated investor's interests in the associate or joint venture."

Paragraph 26 of PAS 28 states:

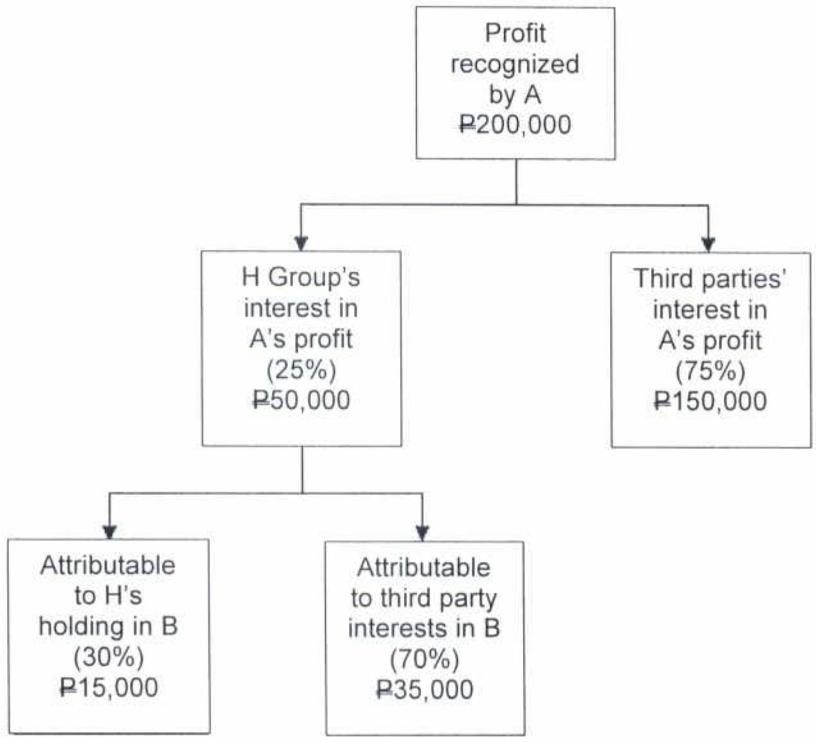
"Many of the procedures appropriate for the application of the equity method are similar to the consolidation procedures described in PFRS 10."

Paragraph B86(c) of PFRS 10, *Consolidated Financial Statements*, states:

"eliminate in full intragroup assets and liabilities, equity, income, expenses and cash flows relating to transactions between entities of the group (profits or losses resulting from intragroup transactions that are recognized in assets, such as inventory and fixed assets, are eliminated in full)."

The fact that paragraph 28 of PAS 28 only refers to the upstream and downstream transactions is considered to be an illustration of the requirements of paragraph 26 of PAS 28 of the typical transactions to be eliminated and are not the only situations to be eliminated by this principle. Therefore, applying the same principles in paragraph 28 of PAS 28 and paragraph B86(c) of PFRS 10, the unrealized profit in the investor's financial statements arising from any transaction between the associates and/or joint ventures is eliminated to the extent of the related investor's interests in the associates and/or joint ventures, as appropriate.

An illustration of the elimination of profit follows:



Effective Date

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Date approved by PIC: June 28, 2017

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Date approved by FRSC: DEC 13 2017

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

Q&A No. 2017-06

PAS 2, 16 and 40 – Accounting for Collector's Items

Issue

How does an entity account for collector's items (e.g., paintings, rare items, vintage items, classic cars) under the following scenarios?

Scenario 1: The entity holds collector's items for administrative or aesthetic purposes (e.g., paintings placed on the walls in the entrance hall or conference rooms).

Scenario 2: An entity invests in collector's items for long-term investment purposes. The entity does not trade these collector's items in the ordinary course of business.

Scenario 3: An entity invests in collector's items for short-term investment purposes. The entity also trades these collector's items in the ordinary course of business.

Consensus

Collector's items do not meet the definition of intangible assets under PAS 38, *Intangible Assets*, because they have physical substance. As defined under Paragraph 8 of PAS 38, intangible assets are identifiable non-monetary assets that do not have physical substance. Therefore, in determining the appropriate accounting for collector's items, entities must consider the purpose for which the collector's items is held.

Scenario 1

Items that are collected for administrative / aesthetic purposes and are not traded in the ordinary course of business meet the definition of an item of property, plant and equipment under paragraph 6 of PAS 16, *Property, Plant and Equipment*. Accordingly, the entity measures a collectible at cost at initial recognition. Subsequently, the entity measures the collector's items under the guidance provided for by PAS 16; that is at either cost less accumulated depreciation or at revaluation model, provided that the entity can measure the fair value of the collector's items reliably.

In accounting for the collector's items in accordance with PAS 16, the entity should also assess the residual value of a collectible. Generally, at initial recognition, such residual value is close to its purchase price, thus, the depreciable amount for a collectible is generally negligible. In addition, since these collector's items are held for administrative / aesthetic purposes, they do not independently generate cash inflows. Therefore, when testing for impairment, the entity should test these collector's items for impairment on the level of the cash-generating unit to which they relate, or as corporate assets.

Scenario 2

PFRS does not have specific guidance on the accounting for collector's items held for long-term investment purposes. Entities will therefore need to refer to the hierarchy of guidance in the selection of accounting policies laid out in PAS 8, *Accounting Policies, Changes in Estimates and Errors*, and consider the guidance under other PFRS / PAS that deal with similar and related issues.

Therefore, an entity refers to PAS 40, *Investment Property*, because PAS 40 deals with assets (land and other tangible assets) that an entity holds for long-term investment purposes when the entity is a passive investor, which are similar to collector's items held for long-term investment purposes:

- They both have a physical, tangible nature (i.e., a non-financial asset);
- They both are often, rare, unique and individually valuable;
- They both do not have a fixed life that limits the ability of the entity to hold the item long-term;
- They both are not used in the production or supply of goods or services;
- They both are held primarily for the benefit of investors.

With the above, an entity can apply PAS 40 by analogy and recognize the collector's items at cost upon initial recognition. Subsequently, the entity accounts for the collector's items either at cost less accumulated depreciation or at fair value, provided that such fair value can be measured reliably, with the gains and losses from the change in fair value recognized in profit or loss.

Unlike Scenario 1, under this scenario, these collector's items can generate cash flows upon sale independently from other assets. Therefore, the entity tests collector's items held for long-term investment purposes for impairment at the asset level.

Scenario 3

Similar to Scenario 2, PFRS has no specific guidance on the accounting of collector's items held for short-term investment purposes or trading in the ordinary course of business. Applying the hierarchy guidance stated in PAS 8, an entity refers to PAS 2, *Inventories*, as this standard deals with assets that an entity holds for trading in the ordinary course of business. Therefore, an entity will initially recognize such collector's items at cost and subsequently measure them at the lower of cost and net realizable value in accordance with the requirements of PAS 2.

If the characteristics of the collector's items are similar to those of a commodity, and the entity qualifies as a broker or trader in accordance with paragraph 3(b) of PAS 2, the entity will initially recognize such collector's items at cost and subsequently measure them at fair value less costs to sell.

Since determining the appropriate accounting for collector's items also require judgment, an entity should consider the requirements of paragraph 122 of PAS 1, *Presentation of Financial Statements*, on disclosing judgment management has made in the process of applying the entity's accounting policies on collector's items.

Effective Date

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Date approved by FRSC: DEC 13, 2017