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Argument For Capitalizing Interest On Debt

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An Argument For Capitalizing Interest On Debt

By Glenn Jones

During the past eighty years much has been written in accounting literature concerning various methods of accounting for interest costs. Many different proposals have been put forth, several of which have advocated capitalizing interest costs. At the present time most companies treat interest costs as period expenses.[1] However, the percentage of companies adopting a policy of capitalizing interest has been increasing in recent years.

The increase in the number of companies starting to capitalize interest as part of the cost of certain assets created considerable concern at the Securities and Exchange Commission. The SEC stated that "it does not seem desirable to have an alternative practice grow up through selective adoption by individual companies without careful consideration of such a change by the Financial Accounting Standards Board."[2] Accordingly, in November 1974 the SEC barred companies (except for utilities, real estate companies, and savings and loan associations) that were not already capitalizing interest from doing so. In December, 1978, the FASB issued an Exposure Draft of the proposed statement *Capitalization of Interest Cost,* and is presently reviewing comments received prior to March 31, 1979.

The Discussion Memorandum that preceded the ED addressed the selection of proper accounting and reporting treatment of interest cost. The issue is not as simple as it appears. Accounting Research Bulletins, Opinions of the Accounting Principles Board, AICPA Industry Accounting and Audit Guides, and Accounting Research Studies have very little to say about the subject. In some cases guidelines given are in conflict with each other. Pronouncements by the SEC in this area have also been sparse. Several agencies and organizations have expressed views on the manner in which they believe interest costs should be handled, but no two believe that interest expense should be handled in exactly the same way. Clearly there exists a need for some degree of uniformity.

Three alternatives were discussed in the DM, as follows:[3]

"1. Account for interest on debt as an expense of the period in which it is incurred;

2. Capitalize interest on debt as part of the cost of an asset when prescribed conditions are met;

3. Capitalize interest on debt and imputed interest on stockholders' equity as part of the cost of an asset when prescribed conditions are met."

Arguments for and against all three alternatives were presented in the DM, and a summary of those comments with regard to Alternatives 1 and 2 appears later in this paper. The third proposal, however, which recognizes imputed interest on stockholders' equity whether capitalized or not, will not be discussed, inasmuch as issues dealing with fundamental changes in the measurement of earnings and asset values are being discussed in the FASB project on the conceptual framework. The third proposal, therefore, will not be seriously considered until the Board has finished with the conceptual framework.

Alternatives 1 and 2 are identical in their treatment of interest expense in the majority of situations. Both alternatives limit accounting recognition to interest on debt. Both account for interest on debt in most cases as an expense of the period in which it is incurred. Alternative 2, however, called for the interest on debt to be capitalized as part of the cost of the asset when certain conditions were met. The prescribed conditions were as follows:[4]

"1. There is significant holding period between the outlay of funds to purchase or construct an asset and its use or sale in the intended revenue-earning activities.

2. A significant holding period prior to use or sale is necessary to bring about a physical change that adds value to the asset.

3. There is special evidence that the interest capitalized will be entirely recoverable.

4. The funds used to acquire the asset were specifically borrowed for that purpose."

The current Exposure Draft proposes that Alternative 2 (with the first and second of the above prescribed conditions) is the proper manner in which to account for interest costs. Admittedly there are problems to be solved, but these problems are not insurmountable. Opponents contend that since funds are fungible, it will be impossible to ensure that the funds used to obtain an asset are the same funds that were borrowed. Some proponents believe that a statement from management that the funds for the asset were obtained from a specific borrowing is sufficient. Additional procedures to allay these fears include securing the debt with the asset or specifying in the debt instrument the purpose for which funds are to be used.

Opponents state that there exists no cause-and-effect relationship between the borrowing of funds and the revenues generated from their use. This statement is indefensible since the borrowed funds allowed acquisition of the asset in the first place. The interest costs incurred to obtain the asset are as much a part of the cost of the asset as the components of the asset itself.

In the case where funds are borrowed to construct an asset, capitalization of the interest results in a total cost closer to that recorded if the asset is purchased. The purpose is not to approximate the cost of the purchased asset; the purpose is to recognize the total cost of the asset, and this should include at a minimum the interest on the funds borrowed to build it. If the asset is purchased in a condition ready for use, the price must be high enough for the seller to make a return on his investment. The selling price thus includes a cost-of-funds element, and this element should also be recognized when the asset is self-constructed.

Critics note that capitalizing interest on debt will lead to similar assets appearing on the balance sheets at different amounts, since some will have been purchased with borrowed funds and some with an enterprise's own funds. They are correct. However, the situation is scarcely different from that which already exists. Historical cost accounting itself causes similar assets to have different carrying values. To reject capitalization of interest on this basis implies a rejection of historical cost accounting also and, while many advocate precisely this rejection, the fact is that historical cost remains the accepted method in this country.

Another criticism of capitalizing interest deals with the quality of earnings. Opponents believe that treating interest as a period expense results in a net income of better quality than that obtained by capitalizing interest. Their logic is that expensing interest results in a net income figure that is closer to the actual flow of cash receipts and disbursements. This is the equivalent of saying that cash accounting is better than accrual accounting. Most people recognize that exactly the opposite is true.

A final argument offered by proponents of expensing interest is concerned with the implemental problems associated with capitalizing interest. They correctly point out that capitalization rates, asset bases, capitalization periods, and amortization periods will all have to be determined. They prefer to avoid these problems by simply charging the interest to expense in the period incurred. Unquestionably expensing interest would be easier.

The Board's Exposure Draft proposes capitalizing interest cost as part of the historical cost of acquiring an asset if a significant period of time elapses between the initial expenditure related to development of the asset and its readiness for its intended use *and* if such period of time is required to bring the asset to the condition and location necessary for its intended use. For purposes of the proposed Statement *interest cost* includes interest recognized on obligations having explicit interest rates, interest imputed in accordance with APB Opinion No. 21, and interest relating to a capital lease determined in accordance with FASB Statement No. 13. It excludes interest that might be imputed on owners' equity.[5]

The method chosen to account for interest costs must realistically depict what is happening. Expensing interest costs in all situations is not realistic. Capitalizing interest costs in all situations is not realistic. Expensing interest costs in most cases, however, and capitalizing interest costs when certain, well-defined criteria are met is, if not the ultimate answer, at least a step in the right direction. □

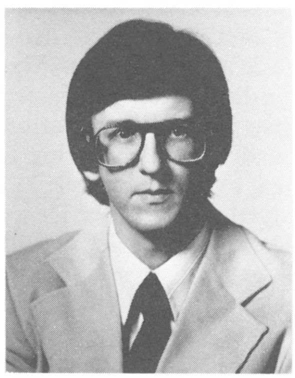
[1]Ernst & Ernst, "FASB Wants Input On Accounting for Interest," *Financial Reporting Briefs*, January, 1978, (Cleveland, Ohio: Ernst & Ernst, 1978), p. 8

[2]Securities and Exchange Commission, Accounting Series Release No. 163, *Capitalization of Interest by Companies Other Than Public Utilities*, (New York, N.Y.: November 14, 1974)

[3]Financial Accounting Standards Board Discussion Memorandum, *Accounting for Interest Costs*, (Stamford, Conn.: FASB Dec. 16, 1977)

[4]Ibid.

[5]Financial Accounting Standards Board Exposure Draft, *Capitalization of Interest Cost*, (Stamford, Conn.: December 15, 1978) Par. 1 and Par. 8. See also Par. 9 for examples of kinds of assets that qualify for interest capitalization.



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