Capitalizing Interest Costs: A Closer Look

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In October 1979, The Financial Accounting Standards Board (FASB) issued its Statement of Financial Accounting Standard No. 34, "Capitalization of Interest Cost."[1] Except for some isolated situations such as the accounting practice in the regulated utility industries, it has been a conventional accounting practice to account for interest costs as period costs which are expensed against revenues of the accounting period. When interest rates were much lower than they have been over the past decade or so, expensing interest as incurred may well have been viewed as appropriate because it led to conservative income measurement and often was not a material element in income determination. Lately, however, an increasing number of firms found it desirable to capitalize a portion of their interest costs. This is attributable to more business firms raising debt capital to finance their operations due to the tax deductions on interest and the impact of inflation on future payments. Another factor influencing capitalization is the dramatic increase in corporate debt interest rates. Becoming alarmed by the discernable trend of interest capitalization, the Securities and Exchange Commission imposed a moratorium on the adoption or extension of this practice in 1974 through the issuance of Accounting Series Release No. 163, "Capitalization of Interest by Companies Other Than Public Utilities."[2]

The Financial Accounting Standards Board took on the challenge of ASR No. 163. SFAS No. 34 resulted from FASB's deliberations which reflect drastic departure from the conventional accounting practice.

The FASB issued an *Exposure Draft,* "Capitalization of Interest Cost in Financial Statements that Include Investments Accounted for by the Equity Method" on September 30, 1981. The major thrust of the draft was to include investments in other companies accounted for by the equity method as a qualifying asset for interest capitalization. This is a logical extension of the definition of qualifying assets inasmuch as investments in other companies are income oriented as are plants being constructed for the investor. The draft states that interest incurred on the investment up to the date the investor commences its planned principal operations should be capitalized. This type of asset should qualify for the interest capitalization.

This paper basically supports the tenets reached in SFAS No. 34; however, it behooves the reader to note that certain conceptual problems remain embodied within the Statement. These shortcomings are noted along with their suggested solutions. To facilitate subsequent discussions, relevant provisions of SFAS No. 34 are first summarized below, followed by observations on their potential impact on financial accounting and reporting, and by comments on the more fundamental, conceptual issue of interest capitalization.

Highlights of SFAS No. 34

Pertinent requirements of FASB Statement No. 34 are summarized below:

1. *Qualifying Assets* — To qualify for interest capitalization, assets must require a period of time to get them ready for their intended use. Qualifying assets are assets that an enterprise constructs or produces for its own use (such as facilities), and assets that are constructed as discrete projects and intended for sale or lease (such as ships or real estate projects). Investment in other companies that are in a pre-operating status and are being accounted for by the equity method are also qualifying assets. Interest capitalization is required for those assets if its effect, compared with the effect of expensing interest, is material.
2. *Eligibility for Capitalization* — The interest cost which is eligible for capitalization includes any of the following:
   a. Interest on obligations having implicit interest rates.
   b. Interest imputed in accordance with APB Opinion No. 21, "Interest on Receivables and Payables."
   c. Interest related to a capital lease as per FASB Statement No. 13, "Accounting for Leases."

   The total amount of interest cost capitalized in an accounting period shall not exceed the total amount of interest cost incurred by the enterprise in that period.
3. *Capitalization Rate* — The capitalization rates shall be based on rates applicable to borrowings outstanding during the period. If a specific borrowing is related to an asset under construction according to the financing plan, the enterprise may use the rate associated with that specific borrowing as the capitalization rate, up to the amount of that borrowing. Otherwise, a weighted average rate shall be used. The capitalization rate is to be applied to the average amount of accumulated expenditures for

Table 1

Effect of Interest Capitalization on Income Statement

	Income Statement(s) for Period(s) Prior to Use or Sale of Asset	Income Statement(s) for Period(s) Of Use or Sale of Asset	Income Statements During Asset's Lifetime
Cost of sales/depreciation	—	Increase	Increase
Interest expense	Decrease	—	Decrease
Provision for income taxes	Increase	Decrease	None
Net income	Increase	Decrease	None

Source: FASB Discussion Memorandum, 1977, p. 48.

the asset under construction during the period.

4. *Capitalization Period* — Capitalization shall begin when all of the following conditions exist:
   a. Expenditure for the asset has been made.
   b. Activities to get asset ready are in progress.
   c. Interest cost is being incurred.

   Interest capitalization is to cease when the asset under construction is essentially complete and ready for its intended use.
5. *Disclosure* — The amount capitalized and the total amount of interest payments during the accounting period shall be disclosed.
6. *Effective Date* — The Statement shall be applied prospectively in fiscal years beginning after December 15, 1979, and shall not be applied retroactively for previously issued annual financial statements.
7. *Exemption* — The regulated industries are exempted from the requirements of this Statement, pursuant to the Appendix to APB Opinion No. 2.

Impact on Financial Accounting and Reporting

Recording interest as an acquisition cost of an asset will affect both the balance sheet and the income statement. Due to the inclusion of interest as an element of the cost of acquisition, the amount reported for qualifying assets would be higher than what would be the case under the current practice. Thus, the associated financial position ratios will be effected.

The income statement is also affected because the reported earnings would be affected. SFAS No. 34 has the effect of deferring an item of expense to future charges against future revenues. Over a long period of time, the difference between charging the interest cost directly to expense, on the one hand, and adding it to the cost of assets and increasing depreciation expense, on the other hand, would have little aggregate effect. But the short-run effect on periodic income could be significant. Since financial statements are prepared on a periodic basis, the short-run effect has great importance. As noted in a subsequent paragraph, it would appear that SFAS No. 34 presents increased opportunities for manipulation of reported earnings.

Table 1 summarizes the income statement effect of capitalizing debt interest as presented in the FASB Discussion Memorandum on Accounting for Interest Costs.[3]

According to Sec. 226 of the 1954 Internal Revenue Code, interest and taxes may be capitalized as an asset cost for certain real and personal property. However, the taxpayer has the choice to deduct the interest or capitalize it. In most cases, the former would be chosen, and the cash flow for tax payments would remain unchanged from circumstances existing prior to SFAS No. 34. Thus, the resulting economics of SFAS No. 34 have a negligible effect upon cash flow but a noticable impact on reported financial information.

SFAS No. 34 does not require retroactive application of interest capitalization. The effect of not requiring retroactive application is most noticable in the earlier years, especially in the year of adoption of the Statement. A drastic increase in earnings per share is made possible by a mere change in the accounting treatment of interest costs. This effect is to be expected, since costs of operations during the transition period are understated based on the provision of SFAS No. 34 to capitalize interest costs only on a prospective basis. Annual reports of business enterprises showing "windfall profits" may be anticipated for the first few years after SFAS No. 34 becomes effective. By not allowing retroactive treatment, those enterprises which previously did not capitalize interest will reflect lower charges to earnings (since capitalized interest is not included in the assets being depreciated or charged-off at the point of sale) than enterprises which previously capitalized interest. Thus operating results will not be comparable until there has been a sufficient passage of time to reduce the impact of the non-capitalization practice which existed prior to the effective date of the FASB Statement 34. To correct this lack of comparability, it is recommended that the Statement be applied on a retroactive basis. It should be noted that the SEC's moratorium of 1974 did not prohibit companies which had publicly disclosed their interest capitalization practice from continuing such a practice.

The extent of the impact of interest capitalization on reported earnings is somewhat related to the relative levels of capitalized interest and of earnings before taxes. As might be expected, a small business enterprise with modest earnings will show a major increase in earnings per share if it undertakes a major expansion program via debt funding. This points out an opportunity for an enterprise to manipulate its earnings figure by potential abuses of the provisions of SFAS No. 34. It seems to provide incentive for an enterprise to modify its existing financing policy. A company with sufficient funds to finance a project may elect to borrow so that the interest on debt could be capitalized and the available funds could be invested to generate income.

It is felt that there are several areas in which problems related to the application of SFAS No. 34 may arise. These are individually addressed in the following section. Although these weaknesses do exist, they can be corrected. Once corrected, the Statement will give added useful information.

Potential Problem Areas

Qualifying assets are defined in SFAS No. 34 as those intended for an enterprises's own use or for sale/lease. There is no guidance as to how to allocate interest cost if assets are being constructed both for sale and for own use, and if the total amount of qualifying assets exceeds the amount of borrowings. For example, suppose the enterprise borrows $1,000,000 to partially finance the construction of a $1,000,000 asset for its own use and another $1,000,000 asset for sale. If the interest cost is allocated to the asset being constructed for its own use, the effect on the income statement would be substantially different from that which would exist if the interest cost is allocated to the asset intended for sale. The company's own asset would be depreciated over its useful life, and the interest would be recognized as expense over this period. On the other hand, interest capitalized in an inventory item would be expensed as soon as the asset is sold. Similar allocation problems may arise if there are several different assets being constructed during the same period. The allocation can be very subjective. The allocation process must be based on some objective basis. One such approach could be a weighted average percentage of all assets being constructed during that time period. This is comparable to the allocation of joint costs on a relative sales value basis.

One of the conditions necessary for initiating and continuing the capitalization period is that activities that are necessary to get the asset ready for its intended use must be in progress. According to SFAS No. 34[4]:

> "The term activities is to be construed broadly. It encompasses more than physical construction, it includes all the steps required to prepare the asset for its intended use."

Given this definition of the term "activities," it is conceivable that an enterprise could undertake certain activities which are relatively superficial in nature, yet which may be argued as "steps required to prepare the asset for its intended use," thereby extending the capitalization period while in effect the asset is on a holding pattern. It would seem that the FASB must specify what activities qualify to meet the conditions of the paragraph. If this is not done, too much latitude exists for the firm doing the construction. The independent CPA will be faced with the problem of interpreting this rule which will lead to variations in implementing the Statement.

If an enterprise's financing plan associates a specific borrowing with a specific qualifying asset, the rate of this specific borrowing may be used as the capitalization rate. A weighted average rate of other debt would be applied to the amount of expenditures for the qualifying asset in excess of the specific borrowing. There are a number of problems associated with these provisions of SFAS No. 34.

First of all, the association of debt with assets appears to be a subjective basis for objective accounting. The results of an enterprise's operation may be altered at management's discretion by adjusting the financing plan. Borrowed funds originally intended for operational needs could be diverted to qualified asset procurement and the interest could be capitalized rather than expensed. Thus, to avoid the opportunity for manipulation, it would appear that interest costs incurred during construction periods should be capitalized, regardless of the use of the debt funds. The interest could be allocated using the weighted average percentage basis mentioned earlier.

Problems exist in allocation of construction interest costs, and in qualifying assets.

SFAS No. 34 allows considerable latitude in determining the weighted average rate. For example, all borrowings of a parent company and its subsidiaries may be included in arriving at the weighted average rate. It is questionable that this combination reflects the economic reality of the borrowing rate because the rate for each subsidiary is dependent upon factors peculiar to each firm. Any combination of debt selected from these borrowings is also permitted. The pick-and-choose procedure allowed by SFAS No. 34 is a subjective one, and is potentially capable of being abused to manipulate reported earnings.

Furthermore, the use of a weighted average rate seems to be based on the premise that funds are fungible. On the other hand, funds are considered traceable in SFAS No. 34 because specific debt may be associated with particular assets. Thus, funds are both fungible and traceable — an apparent contradiction.[5]

It is a matter of fact that debt for any purpose cannot be isolated from other obligations of the enterprise. The rate of interest on a specific borrowing will reflect the overall capital structure of the enterprise. Additionally, most large construction projects are supported by various sources of corporate funds which are in constant flux. It would seem logical and practical, therefore, to use as the capitalization rate the average cost of all obligations of that particular entity which give rise to interest costs for the entire period.

In some cases excess funds borrowed for a specific purpose are invested to earn income until the time they are needed for the specific purpose for which they are borrowed. The question of whether this interest

Interest capitalization produces a significant short-run effect on financial position ratios.

income should be offset against interest expense in determining the amount of interest cost available for capitalization is not addressed in SFAS No. 34.

On December 22, 1981, the FASB issued an *Exposure Draft* entitled "Capitalization of Interest Cost in Situations Involving Tax-Exempt Borrowings and Certain Gifts and Grants," as an amendment of FASB Statement No. 34. The proposed conclusions of the Board are that:

1) When proceeds of tax-exempt borrowings are temporarily invested, the capitalized cost of the borrowings shall be decreased by any interest earned on related interest-bearing investments from the date of the borrowing until the asset is ready for its intended use.
2) No interest cost will be capitalized on the portion of a qualifying asset acquired with a gift or grant that is restricted by the donor or grantor to acquisition of the specified asset. Interest earned on temporary investment of those funds that is similarly restricted will be considered an addition to the gift or grant.

Another minor issue concerns the impact compensating balances have on the effective interest cost of borrowed funds. It is clear that a requirement to maintain compensating balances increases the borrowing's effective interest rate, and this cost should be included in determining the capitalization rate.

Conceptual Issue of Interest Capitalization

Capitalization of interest cost is a controversial issue, and opinions differ within the accounting profession and within the FASB as to how best to treat the element of interest in financial accounting and reporting. SFAS No. 34 was adopted by a vote of 4 to 3, with the Chairman of the FASB voting against it[1]

This author concurs with the conclusion reached by the majority of the FASB Board. The concurrence is based on practical grounds rather than conceptual logic.

Ideally the acquisition cost of an asset should include all costs incurred to place that asset in a condition suitable for its intended use. The cost of capital employed during the period of construction of an asset is as much a part of its cost as the cost of materials, labor and allocated overhead. This view is consistent with the concept of historical cost, a fundamental accounting principle. It is also in line with the economist's view that cost of capital is a cost of assets.

Given the constraints of the historical cost accounting model, the issue germane to this section of the paper concerns how to best account for cost of capital. There are three options:[6]

a. Capitalize interest on debt and imputed interest on equity.
b. Capitalize interest on debt.
c. Capitalize nothing; expense interest on debt as period cost.

The pros and cons of each of these options have been amply documented in the FASB Discussion Memorandum, and they will not be repeated here.

Of these options, only the first one is conceptually sound and in accord with the economic facts. The FASB adopted the second option as a compromise between the conceptually sound accounting alternative and the limitations of the present accounting model. This author agrees with that decision, and the basis for agreement will be mentioned later. The three dissenting members of the FASB elected the third option, which was the current practice.

If the cost of capital were not capitalized, it would not be possible to properly match costs with related revenues. Charging the costs of capital to expense would ignore the fact that the costs were incurred to generate future revenue, not to sustain current operations. Additionally, immediate charge-off would cause future earnings to be inflated because the interest costs associated with the future revenue would have been expensed in earlier periods. Thus, the current practice of expensing all interest costs is conceptually incorrect and might be modified; however the practical significance of this proposed change is questionable, and reference is made to this in a subsequent paragraph.

In recent years, two notable figures in the accounting profession have spearheaded a movement aimed at adopting the first option stated above. Because of the failure to recognize the cost of capital as an element of acquisition cost, "present financial accounting does not reflect economic reality. Worse than that, it creates an illusion of enormous profits where often no true profit exists, thus making some corporations look far better than they really are."[7] Without recognizing the cost of equity capital, "a capital acquisition could actually cause a decrease in the profits reported for the early years after the asset became productive, even though the profit center was in fact more profitable."[8] In this respect, it is noted that managerial accounting does impute the cost of capital in investment decision models which generate economic information for internal use. Users of financial statements, however, would not formally have access to such information.

According to Paragraph 41 of the Exposure Draft in which the FASB expressed its majority view, "a valid conceptual argument exists for basing capitalization of interest on enterprise cost of capital which would include imputed interest on equity capital as well as interest on borrowed capital."[9]

Nevertheless, an imputed rate of interest must be determined and this rate is not readily determinable based on recorded transactions within the present accounting framework. Practical difficulties impede the implementation of the concept of capitalizing the cost of equity capital. Furthermore, it would not be proper to base the imputed cost of equity capital on the exchange prices when equity securities were issued because such an imputed value would not fairly represent the cost of equity funds employed in the current asset construction project.[10]

The utility industry has been allowed to impute cost of equity for capitalization purpose for more than half a century; however, this industry still does not agree on a "definite standard and related methodology as to how the rate for capitalization of interest during construction should be developed."[11]

The reason for the continuing controversy in the utility industry is attributable to "attempts by the regulatory agencies to apply a narrow interpretation to the term 'interest' and otherwise to limit the amount that a utility may rightfully categorize as 'interest during construction'."[12] The matter remains unsettled for the regulatory utility industry.[13]

Anthony, who advocates the practice of capitalizing cost of equity, also recognizes the practical aspects of implementation. He suggested, however, that it is better to be "approximately right than entirely wrong."[14] Namely, it is better to estimate the imputed cost of capital than to omit this cost simply because the amount cannot be measured precisely.

This author does not agree with such a view because the current historical cost model does not provide for imputed equity interest capitalization. Furthermore, there is an empirical finding which tends to support the FASB's decision to not require capitalization of the cost of equity capital.[15] The investigation determined the effect of accounting recognition of cost of equity on the relationship between earnings per share and stock returns. Compared to the association between the conventional earnings per share and stock returns, recognizing the imputed cost of equity would result in a weaker association. The message seems to be that information based on recognition of equity cost does not have much practical significant relevance to the investor's decision making. Inasmuch as the marketplace attributes negligible significance to equity interest capitalization, it would seem a violation of the cost/benefit rule to require this type of disclosure. Thus, the conclusions reached by the FASB appear to be supported from a practical viewpoint.

Conclusion

SFAS No. 34 embodies a compromise between the sound accounting concept of recognizing the cost of capital as an element of an asset's acquisition cost, and the practical limitation of the historical cost accounting framework which prohibits recording the cost of the equity capital. A number of implemental issues are raised in this paper. However, the issues are not insurmountable. The following are recommended to overcome the identified potential problem areas:

a. Consideration should be given to apply SFAS No. 34 on a retroactive basis so as to minimize the impact on financial statements during the transition period.

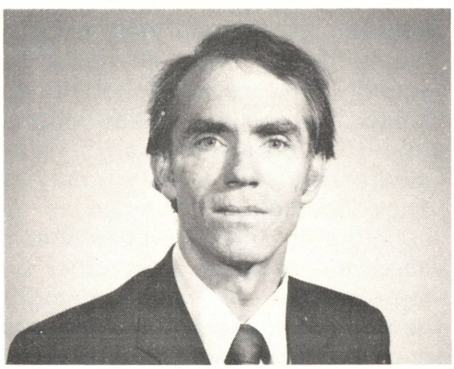
b. The interest cost should be allocated among qualifying assets in proportion to the level of expenditure for each asset.

c. Superficial "activities" should not be permitted to justify the initiation or continuation of the capitalization period.

d. The capitalization rate shall be the weighted average cost of all obligations of the specific enterprise.

As opposed to a mass of rules to provide for every possible practical situation, SFAS No. 34 includes broad guidelines to be used in capitalizing interest costs in conformity with the principle of matching costs with revenues. The Board has applied cost/benefit considerations which resulted in workable rules to provide material information for better reflecting the economic reality of business enterprises. This information should be useful to potential users of financial statements; however, it is up to the accounting profession to persuade potential users of financial statements of the fact that SFAS No. 34 is indeed proper and justifiable. Ω

The utility industry still debates standards for capitalizing interest on equity.



Louis P. Ramsay, CPA, D.B.A., *is associate professor of accounting at Clemson University in South Carolina. He has been affiliated with Peat, Marwick, Mitchell & Co., and with the faculty of Eastern Michigan University, and SUNY at Fredonia. He is a member of American Accounting Association.*

NOTES

1 Statement of Financial Accounting Standards No. 34, "Capitalization of Interest Cost," FASB, Stamford, Conn., October, 1979.

2 Accounting Series Release No. 163, "Capitalization of Interest by Companies Other Than Public Utilities," Securities Exchange Commission, Washington, D.C., 1974.

3 Discussion Memorandum, "An Analysis of Issues Related to Accounting for Interest Costs," Financial Accounting Standards Board, Stamford, Conn., December 16, 1977.

4 SFAS No. 34, op. cit., para. 17.

5 Discussion memorandum, op, cit.

6 Ibid.

7 P. L. Defliese, "What Makes Profits Look 'Obscene'," *Business Week*, August 4, 1975, pp. 10-11.

8 R. N. Anthony, *Accounting for the Cost of Interest*, Lexington Books, Lexington, Mass., 1975, p. IX.

9 Exposure Draft, "Capitalization of Interest Cost," FASB, Stamford, Conn., Dec, 15, 1978, p. 18.

10 SFAS No. 34, op, cit., p. 24.

11 J. F. Utley, "Yet Another View of Interest During Construction," *Selected Papers*, Haskins & Sells, 1971, pp. 89-94.

12 H. E. Sayad, "An Accountant Looks at Capitalized Interest," *Selected Papers*, Haskins & Sells, 1967, pp. 120-130.

13 R. R. Trout, "A Rationale for Preferring Construction Work in Progress in the Rate Base," *Public Utilities Fortnightly*, May 10, 1979, pp. 22-26.

14 Anthony, op. cit., p. 19.

15 B. Lev and D. W. Taylor, "Accounting Recognition of Imputed Interest on Equity: An Empirical Investigation," *Journal of Accounting, Auditing and Finance*, Spring 1979, pp. 232-243.