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A Reconsideration of Capitalizing Interest Costs

An Even 'Closer Look'

By Donna A. Dingus and Roland L. Madison

The fall of 1979 saw the issuance of two very controversial standards by the Financial Accounting Standards Board (FASB). These were Statements No. 33 and No. 34. This discussion is confined to the latter Statement since a wealth of empirical evidence about the problems encountered with the inflation accounting statement (SFAS No. 33) is being published in the literature, and SFAS No. 34 certainly deserves equal individual treatment.

It appears that the Board will continue to compound the problems of SFAS No. 34 with other pronouncements related to the capitalization of interest (SFAS Nos. 58 and 62) unless some rather logical objections are raised. Perhaps it is not too late for the Board to reconsider Statement No. 34 as it has done in the past when it became apparent that such deliberations were necessary.

Earlier this year, Professor Ramsay (*The Woman CPA*, April, pp. 3-7) titled his article "Capitalizing Interest Costs: A Closer Look." After a thorough reading of that article and related accounting literature, it is difficult to comprehend why he sincerely maintains that support for Statement No. 34 by the accounting profession is proper. Many of his observations show that he in fact does grasp, but to a lesser degree, the extent and significance of the conceptual problems that are associated with SFAS No. 34 and the pragmatic problems that it actually instigates. The approach in this article is to take "an even closer look" at SFAS No. 34 in terms of Professor Ramsay's article, and in several instances highlight some of the points we perceive as rather serious problems.

It is believed that many business people and academicians will agree that a prompt reconsideration of SFAS No. 34 is in order. The problems discerned in many cases will be made evident by asking some rather provocative questions about the logic and theory supporting the capitalization of interest.

Rising Interest Rates: A "Material" Concern

The relatively rapid and continuous rise in interest rates during the past decade was given as a justification for the capitalization of interest as an element of the acquisition cost for selected assets. Prior to this trend, the rationale was that noncapitalization with lower rates "led to a conservative income measurement and often was not a material element in income determination" (Ramsay, p. 3).

Given this manner of using materiality as a justification for including interest as a cost of acquisition, would logic dictate that if interest rates began a significant decline that noncapitalization of interest would again be most appropriate? Perhaps some form of the lower-of-or-market method might be designed with some benchmark rate specified as the "cost rate" to regulate when to capitalize. An alternative to this not so unrealistic bit of sarcasm is presented later in our discussion.

The Historical Cost Principle as Basis for Capitalization

The second and certainly more logically sounding justification presented for the capitalization of interest is the applicability of the "cost principle." Upon closer scrutiny, this justification has more holes than (and the aroma of) a fisherman's net.

For an expenditure to be capitalized, two tests have been historically common throughout the accounting literature (e.g. Paton and Littleton, 1940; APB Statement No. 4, 1970):

1. cost must be bona fide and
2. the asset must have future benefits.

The first point requires the item in question be a true and genuine cost (economic sacrifice) that was actually incurred and was reasonable and necessary for the acquisition of the asset. The latter test requires the enhancement of the economic usefulness or value of the resource as a result of the cost incurrence.

An elaboration on the first point as an entirely separate and extensive topic concerning interest as being an opportunity cost, an avoidable cost, and only one element of the economic cost of capital in total of the firm is beyond the scope and space limitations possible in a single journal article. Some brief references, however, must be made to this point in our overall discussion.

There has been sufficient discussion and development in the literature to consider the latter point to a reasonable conclusion. Presumably the reader accepts the

Conceptual Framework Project as a legitimate basis for the development of generally accepted accounting principles. If so, the "future benefits" test that allows interest to be capitalized as an asset would require that the outlay must "contribute directly or indirectly to future net cash inflows" (SFAC No. 3, 1980, p. 9). If this potential cannot be demonstrated, interest should be rejected as a cost of asset acquisition.

As discussed by Professor Ramsay (p. 6), the Board had three alternatives to consider. The result was obviously a compromise standard that was passed by a vote of 4 to 3 with FASB Chairman Kirk casting a dissenting vote.

As Hendriksen (1982), who even appears to be somewhat supportive of SFAS No. 34, stated the case:

> There is little justification for adding interest in one case and not in the other (meaning the comprehensive capitalization of a normalized cost on all funds used). It is difficult to argue that a building is more valuable simply because it was constructed with borrowed funds rather than funds acquired by the sale of stock (pp. 350-351).

His discussion is logically extended to a point Professor Ramsay mentioned in his article. Hendriksen continued:

> Furthermore, since funds are generally commingled, there is no way of determining what proportion of the asset is financed by debt equity and what proportion by stockholder's equity, except in a new firm (p. 351).

Persons with exposure to industrial accounting at the corporate level no doubt understand why senior financial officers and cash managers of large integrated entities would agree with this rational and quite practical statement. In fact, one outspoken comptroller of a major U.S. corporation stated that the "GAAP" between accounting and economic reality is widening (D.R. Borst, TWIR, July 23, 1982). His suggestions included the abolition of deferred tax accounting, the noncapitalization of leases, and charging interest to expense as a period cost. Overall, he merely advocated a return to the simple economic reality of events as viewed by management in their decision-making processes.

Interest Capitalization and The Conceptual Framework Project

If the Conceptual Framework Project is accepted as the basis for the development of accounting standards, the question arises if the capitalization of interest improves the qualitative content of accounting information. Pointedly, does the inclusion of interest in the cost of an asset provide the users of financial information with improved decision-making usefulness? Does it provide the user with more "relevant" information for decision-making purposes?

The Board defined this qualitative characteristic of accounting information as one giving such information "predictive value." This characteristic means: "Specifically, it is information's capacity to 'make a difference' that identifies it as relevant to a decision" (SFAC No. 2, 1980, p. 21). The all-important phrase "make a difference" may have several valid interpretations, and one of these interpretations is a key part of the Conceptual Framework Project. Stated as a question: Do the requirements of SFAS No. 34 assist the decision-maker "in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (SFAC No. 1, 1978, pp. 17-18)? Or do they, as Professor Ramsay notes, provide management with the potential "for manipulation of reported earnings" (p. 4)?

The Board stated that: "The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components" (SFAC No. 1, 1978, p. 21). Given this primary focus, does an accounting standard that allows for "potential manipulation of reported earnings" lend credibility to the qualitative characteristic of "representational faithfulness" as discussed in SFAC No. 2 for such information to be reliable?

These points have been made to show that the requirements of SFAS No. 34 fail to provide users with improved information that is either relevant or reliable (potentially lacking representational faithfulness and freedom from preparer bias) as well as failing to meet one of the primary objectives of financial reporting.

Does inclusion of interest costs "make a difference" in the predictive values of financial statements?

In short, SFAS No. 34 lacks consistency with the Conceptual Framework Project and sound accounting logic. It is a compromise standard with little theoretical justification. This is the type of position that cannot be maintained for any period of time without numerous amendments, interpretations, and eventually supercession (e.g. SFAS Nos. 8 and 13 and quite likely No. 33).

Accordingly, the Board should review this Standard and either return to the treatment of interest as a financial cost of the period in which it is incurred or accept that all funds, regardless of their source, have an economic cost and capitalize these as a portion of the assets' cost. If there is to be a form of capitalization, the authors prefer an attempt at a direct cause and effect association. This may be accomplished by tracing funding approvals from the Board of Directors as reported in their respective minutes to the segregation of the funding proceeds to the approved projects. All other charges would be treated as period costs instead of being tossed into a general interest pool awaiting an arbitrary allocation approach to be applied. If an all-inclusive capitalization is chosen, the Board may consider using the weighted average cost of capital (all funds) as a basis for determining the total amount of cost to be capitalized.

Several Observations About 'A Closer Look' at the Capitalization of Interest

Several other points gleaned from the article (Ramsay, 1982) show that a closer look at interest capitaliza-

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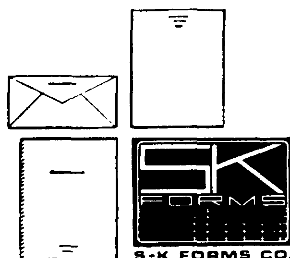

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tion is needed. It was stated that the Internal Revenue Code allows the taxpayer to either capitalize interest as an asset cost or deduct it as an expense. With the latter treatment being chosen more often, "the resulting economics of SFAS No. 34 have a negligible effect upon cash flow but a noticeable impact on reported financial information" (Ramsay, 1982, p. 4).

Is this desirable and consistent with the objectives of financial reporting for potential users attempting to determine the timing, amount, and uncertainty of cash flows? Does this enhance the primary qualitative characteristic of providing "relevant" information if the potential impact on reported earnings is significant but the impact on cash flows is negligible? (Do these questions sound somewhat familiar?)

The answer seems to be a resounding "NO" in each case. The effect of SFAS No. 34 is to widen the difference between reported earnings and income tax accounting and distort the Deferred Income Tax account even more when compounded with the effects of the Economic Recovery Tax Act of 1981. These combined points make income tax allocation and the deferred income tax account even less useful for users of financial statements who are attempting to predict future cash flows.

Another observation is "an abuse" by management described as the "increased opportunities for manipulation of reported earnings" (Ramsay, p. 5) by altering the manner of funding expansion programs. How can the application of promulgated generally accepted accounting principles (GAAP) be called an "abuse?" If management chooses to fund a project by debt rather than equity or internal retention of funds (indirect equity), and thus have a favorable effect on reported earnings, how can anyone label this an abuse? It is simply good financial management—not to mention being mandated by the Board. Obviously the Board, via SFAS No. 34, is the cause of the "potential abuse."

The Board has simply opted for an alternative to pacify two extremes and has created the opportunity for potential abuse in several different manners as discussed by Ramsay. To pursue this thought further, consider what may happen when interest rates decline, as they have done recently, to a point where the capitalization of interest costs is no longer deemed material by some entities, and yet material by others. It will be more interesting to observe interfirm comparability of earnings, ratio and cash flow analysis become quite distorted—and all in the name of GAAP via SFAS No. 34. Perhaps this will be the point where the Board will introduce a benchmark interest rate (materiality quantified by the piecemeal approach, e.g. APB Opinion 15 — 3% dilution test) to determine when capitalization is appropriate. This will certainly assist in the establishment of interest as a bona fide cost to be included as an asset.

The final point that merits some discussion is contained in the conclusion of the article. "The Board has applied cost/benefit considerations . . . for better reflecting the economic reality of business enterprises" (Ramsay, p. 7). The Committee on Concepts and Standards for External Financial Reports (*Statement on Accounting Theory and Theory Acceptance*, 1977) made the observation quite clearly that the "cost-benefit" test in many circumstances, when used as the basis for the development of accounting theory, was of an abstract nature and not capable of proof by quantification. Therefore, one must ask if the Board used differential cost and benefit tests of this information required in SFAS No. 34 on an entity basis, aggregative basis or from a decision-making model used by investors and creditors? As mentioned by the Committee (1977), if authoritative boards and writers were taken to task more often when using the "cost-benefit" phrase as a justification for theory, most would simply admit to administrative dictum or compromise as the true basis for an accounting standard.

Conclusion

The questions raised herein merit an early and closer look at the conceptual arguments given as a basis for the capitalization of interest as an acquisition cost of selected

assets. Consideration should also be given to some of the pragmatic difficulties associated with SFAS No. 34 as mentioned by Ramsay (1982). There is little justification for continuing with a temporary compromise standard when many astute observers can see the problems involved with this Statement. A reconsideration is needed to develop a more logical and lasting standard in the area of interest capitalization. Ω

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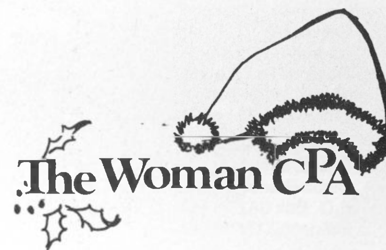

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