Statement of Financial Accounting Standards No. 34

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Capitalization of Interest Cost

October 1979

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

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FAS 34 Summary

This Statement establishes standards for capitalizing interest cost as part of the historical cost of acquiring certain assets. To qualify for interest capitalization, assets must require a period of time to get them ready for their intended use. Examples are assets that an enterprise constructs for its own use (such as facilities) and assets intended for sale or lease that are constructed as discrete projects (such as ships or real estate projects). 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. However, interest cannot be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis.

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. If the enterprise associates a specific new borrowing with the asset, it may apply the rate on that borrowing to the appropriate portion of the expenditures for the asset. A weighted average of the rates on other borrowings is to be applied to expenditures not covered by specific new borrowings. Judgment is required in identifying the borrowings on which the average rate is based.

INTRODUCTION

1. This Statement establishes standards of financial accounting and reporting for capitalizing interest cost as a part of the historical cost of acquiring certain assets. For the purposes of this Statement, *interest cost* includes interest recognized on obligations having explicit interest rates,[1] interest imputed on certain types of payables in accordance with APB Opinion No. 21, *Interest on Receivables and Payables*, and interest related to a capital lease determined in accordance with FASB Statement No. 13, *Accounting for Leases*.

2. Paragraphs 15 and 16 of Opinion 21 provide that the discount or premium that results from

imputing interest for certain types of payables should be amortized as interest expense over the life of the payable and reported as such in the statement of income. Paragraph 12 of Statement 13 provides that, during the term of a capital lease, a portion of each minimum lease payment shall be recorded as interest expense. This Statement modifies Opinion 21 and Statement 13 in that the amount chargeable to interest expense under the provisions of those paragraphs is eligible for inclusion in the amount of interest cost capitalizable in accordance with this Statement.

3. Some enterprises now charge all interest cost to expense when incurred; some enterprises capitalize interest cost in some circumstances; and some enterprises, primarily public utilities, also capitalize a cost for equity funds in some circumstances. This diversity of practice and an observation that an increasing number of nonutility registrants were adopting a policy of capitalizing interest led the Securities and Exchange Commission to impose, in November 1974, a moratorium on adoption or extension of such a policy by most nonutility registrants until such time as the FASB established standards in this area.[2]

4. Appendix A provides additional background information. Appendix B sets forth the basis for the Board's conclusions, including alternatives considered and reasons for accepting some and rejecting others.

5. The Addendum to APB Opinion No. 2, *Accounting for the 'Investment Credit'*, states that "differences may arise in the application of generally accepted accounting principles as between regulated and nonregulated businesses, because of the effect in regulated businesses of the rate-making process," and discusses the application of generally accepted accounting principles to regulated industries. Accordingly, the provisions of the Addendum shall govern the application of this Statement to those operations of an enterprise that are regulated for rate-making purposes on an individual-company-cost-of-service basis.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

6. The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use.[3] If an asset requires a period of time in which to carry out the activities [4] necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

7. The objectives of capitalizing interest are (a) to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset and (b) to charge a cost that relates to the acquisition of a resource that will benefit future periods against the revenues of the periods benefited.

8. In concept, interest cost is capitalizable for all assets that require a period of time to get them ready for their intended use (an "acquisition period"). However, in many cases, the benefit in terms of information about enterprise resources and earnings may not justify the additional accounting and administrative cost involved in providing the information. The benefit may be less than the cost because the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. In that circumstance, interest capitalization is not *required* by this Statement.

Assets Qualifying for Interest Capitalization

9. Subject to the provisions of paragraph 8, interest shall be capitalized for the following types of assets ("qualifying assets"):

a. Assets that are constructed or otherwise produced for an enterprise's own use (including assets constructed or produced for the enterprise by others for which deposits or progress payments have been made)
b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (e.g., ships or real estate developments).

10. However, interest cost shall not be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis because, in the Board's judgment, the informational benefit does not justify the cost of so doing. In addition, interest shall not be capitalized for the following types of assets:

a. Assets that are in use or ready for their intended use in the earning activities of the enterprise
b. Assets that are not being used in the earning activities of the enterprise and that are not undergoing the activities necessary to get them ready for use.

11. Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular use, the expenditures to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those expenditures is a cost of acquiring the asset that results from those activities. If the resulting asset is a structure, such as a plant or a shopping center, interest capitalized on the land expenditures is part of the acquisition cost of the structure. If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land expenditures is part of the acquisition cost of the developed land.

The Amount of Interest Cost to Be Capitalized

12. The amount of interest cost to be capitalized for qualifying assets is intended to be that portion of the interest cost incurred during the assets' acquisition periods that theoretically could have been avoided (for example, by avoiding additional borrowings or by using the funds

expended for the assets to repay existing borrowings) if expenditures for the assets had not been made.

13. The amount capitalized in an accounting period shall be determined by applying an interest rate(s) ("the capitalization rate") to the average amount of accumulated expenditures for the asset during the period. The capitalization rates used in an accounting period shall be based on the rates applicable to borrowings outstanding during the period. If an enterprise's financing plans associate a specific new borrowing with a qualifying asset, the enterprise may use the rate on that borrowing as the capitalization rate to be applied to that portion of the average accumulated expenditures for the asset that does not exceed the amount of that borrowing. If average accumulated expenditures for the asset exceed the amounts of specific new borrowings associated with the asset, the capitalization rate to be applied to such excess shall be a weighted average of the rates applicable to other borrowings of the enterprise.

14. In identifying the borrowings to be included in the weighted average rate, the objective is a reasonable measure of the cost of financing acquisition of the asset in terms of the interest cost incurred that otherwise could have been avoided. Accordingly, judgment will be required to make a selection of borrowings that best accomplishes that objective in the circumstances. For example, in some circumstances, it will be appropriate to include all borrowings of the parent company and its consolidated subsidiaries; for some multinational enterprises, it may be appropriate for each foreign subsidiary to use an average of the rates applicable to its own borrowings. However, the use of judgment in determining capitalization rates shall not circumvent the requirement that a capitalization rate be applied to all capitalized expenditures for a qualifying asset to the extent that interest cost has been incurred during an accounting period.

15. 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. In consolidated financial statements, that limitation shall be applied by reference to the total amount of interest cost incurred by the parent company and consolidated subsidiaries on a consolidated basis. In any separately issued financial statements of a parent company or a consolidated subsidiary and in the financial statements (whether separately issued or not) of unconsolidated subsidiaries and other investees accounted for by the equity method, the limitation shall be applied by reference to the total amount of interest cost (including interest on intercompany borrowings) incurred by the separate entity.

16. For the purposes of this Statement, *expenditures* to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized). However, reasonable approximations of net capitalized expenditures may be used. For example, capitalized costs for an asset may be used as a reasonable approximation of capitalized expenditures unless the difference is material.

The Capitalization Period

17. The capitalization period shall begin when three conditions are present:

a. Expenditures (as defined in paragraph 16) for the asset have been made.
b. Activities that are necessary to get the asset ready for its intended use are in progress.
c. Interest cost is being incurred.

Interest capitalization shall continue as long as those three conditions are present. 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. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities; it includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation. If the enterprise suspends substantially all activities related to acquisition of the asset, interest capitalization shall cease until activities are resumed. However, brief interruptions in activities, interruptions that are externally imposed, and delays that are inherent in the asset acquisition process shall not require cessation of interest capitalization.

18. The capitalization period shall end when the asset is substantially complete and ready for its intended use. Some assets are completed in parts, and each part is capable of being used independently while work is continuing on other parts. An example is a condominium. For such assets, interest capitalization shall stop on each part when it is substantially complete and ready for use. Some assets must be completed in their entirety before any part of the asset can be used. An example is a facility designed to manufacture products by sequential processes. For such assets, interest capitalization shall continue until the entire asset is substantially complete and ready for use. Some assets cannot be used effectively until a separate facility has been completed. Examples are the oil wells drilled in Alaska before completion of the pipeline. For such assets, interest capitalization shall continue until the separate facility is substantially complete and ready for use.

19. Interest capitalization shall not cease when present accounting principles require recognition of a lower value for the asset than acquisition cost; the provision required to reduce acquisition cost to such lower value shall be increased appropriately.

Disposition of the Amount Capitalized

20. Because interest cost is an integral part of the total cost of acquiring a qualifying asset, its disposition shall be the same as that of other components of asset cost.

Disclosures

21. The following information with respect to interest cost shall be disclosed in the financial statements or related notes:

a. For an accounting period in which no interest cost is capitalized, the amount of interest cost incurred and charged to expense during the period
b. For an accounting period in which some interest cost is capitalized, the total amount of interest cost incurred during the period and the amount thereof that has been capitalized.

Effective Date and Transition

22. This Statement shall be applied prospectively in fiscal years beginning after December 15, 1979. Earlier application is permitted, but not required, in financial statements for fiscal years beginning before December 16, 1979 that have not been previously issued. With respect to qualifying assets in existence at the beginning of the fiscal year in which this Statement is first applied for which interest cost has not been previously capitalized, interest capitalization shall begin at that time. With respect to qualifying assets for which interest cost has been capitalized according to a method that differs from the provisions of this Statement, no adjustment shall be made to the amounts of interest cost previously capitalized, but interest cost capitalized after this Statement is first applied shall be determined according to the provisions of this Statement. With respect to assets in existence when this Statement is first applied for which interest cost has been capitalized but which do not qualify for interest capitalization according to the provisions of this Statement, no adjustments shall be made, but no additional amounts of interest cost shall be capitalized.

23. If early application is adopted in financial reports for interim periods of a fiscal year beginning before December 16, 1979, previously issued financial information for any interim periods of that fiscal year that precede the period of adoption shall be restated to give effect to the provisions of this Statement, and any subsequent presentation of that information shall be on the restated basis. This Statement shall not be applied retroactively for previously issued annual financial statements.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Block, Kirk, and Morgan dissented.

Messrs. Block, Kirk, and Morgan dissent to this Statement because, in their opinion, it is founded on a view of interest cost that does not meet the needs of users of financial statements, because it makes the requirement to capitalize interest dependent on meeting an undefined test of materiality, and because it is not evenhanded in the application of its requirements.

Messrs. Block, Kirk, and Morgan consider interest to be a cost of a different order from the costs of materials, labor, and other services in two respects. First, cash—the resource obtained by the payment of interest on debt—has unique characteristics. It is fungible. It is obtained from a variety of sources (principally, earning activities, borrowings, issuance of equity securities, and sales of economic resources), only one of which (borrowings) gives rise to a cost that is recognized in the present accounting framework. The amount of cash (or cash equivalent) given in exchange for a noncash resource provides the basis for measuring the cost of a noncash resource. Because of those characteristics of cash, interest on debt cannot be assigned or allocated to noncash resources in the same way as material, labor, and overhead costs, and association of interest on debt with a particular category of noncash resources, such as assets undergoing a construction or production process, is inherently arbitrary. Second, interest cost is the return to lenders on capital provided by them to an enterprise for a certain period. In the view of Messrs. Block, Kirk, and Morgan, interest cost, like dividends, is more directly associable with the period during which the capital giving rise to it is outstanding than with the material, labor, and other resources into which capital is converted. They acknowledge that the conversion of cash into a nonearning asset entails the sacrifice of the return that the cash could otherwise have earned, but they do not believe that a measure of that sacrifice is a proper addition to the cost of acquiring the asset. In addition, they note that, by attaching an interest cost to all expenditures for a qualifying asset, the prescribed method in this Statement in effect imputes an interest cost to any equity funds that may have been used for it.

Information about the return earned by an enterprise during an accounting period on the capital existing during that period is important to investors and creditors in assessing the enterprise's periodic performance, in assessing the risks of financial leverage, and in assessing their prospects of receiving both return on and return of their investment. Users of financial statements often compute the return earned on the total of debt and equity capital by adding interest expense to reported earnings. Interest capitalization, however, merges interest cost into the costs of assets, with the result that, when the costs of those assets are charged to income in subsequent periods, the interest cost component cannot be distinguished. Thus, the return on total capital in those periods yielded by that computation is misstated. The disclosure requirements of this Statement do not provide the information needed to correct that misstatement.

Messrs. Block, Kirk, and Morgan conclude that charging interest on debt to expense when incurred results in information in the financial statements of all companies that allows the return earned on capital during a period to be readily related on a comparable basis to the capital existing during that period. They believe that information to be more useful in making rational investment, credit, and similar decisions than that provided by including interest cost in the cost of assets.

Messrs. Block, Kirk, and Morgan also believe the discussion of materiality in this Statement will cause confusion. All FASB Statements have contained the sentence, "the provisions of this Statement need not be applied to immaterial items." Heretofore, they believe, FASB standards generally have been followed whenever there was a possibility that noncompliance would have a material effect. In their opinion, paragraph 8 and the amplification of that paragraph in paragraphs 46 and 47 could be viewed as an invitation to search for a new but undefined test of materiality. They believe that search, with the attendant arguments between preparers and auditors and explanations to users as to why interest was not capitalized, will result in more cost, in terms of credibility as well as in a monetary sense, than would compliance with the concept of interest capitalization. They also believe that it is untimely for the Board to elaborate on materiality in a Statement on interest capitalization when an Exposure Draft, *Qualitative Characteristics: Criteria for Selecting and Evaluating Financial Accounting and Reporting Policies*, covering the subject of materiality is out for public comment.

Messrs. Block, Kirk, and Morgan believe a goal of standards is similar accounting for similar situations. In their opinion, because this Statement proscribes interest capitalization for certain inventories, even when the effect is material, and does not define those inventories clearly, this Statement will fail to achieve that goal.

Mr. Morgan also dissents because he believes that the application of this Statement may result in unfavorable economic consequences of significance, such as (a) restructuring of analysis models by financial analysts and other users of financial statements, and (b) possible changes in laws and regulations as a result of reaction to the more liberal profitability concept embodied in this Statement.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

24. Accounting for interest cost was the subject of considerable discussion in accounting literature during the first quarter of this century, but, apart from discussion in accounting textbooks and some articles in regulatory periodicals, relatively little was written on the subject during the next 40 years. The sharp rise in interest rates and increased use of borrowed funds in the last 10 years, however, resulted in renewed attention to the subject.

25. The question of capitalizing interest cost has never been resolved by an authoritative pronouncement of a standard-setting body.[5] In 1971, the Accounting Principles Board (APB) appointed a committee to study the subject. The committee prepared a comprehensive working paper setting forth the principal issues to be considered, but the APB terminated its activities

before a pronouncement could be issued. Accounting for interest cost was also among the many topics originally suggested to the FASB by its Advisory Council and others; however, it was not included on the Board's initial technical agenda.

26. In 1974, the Securities and Exchange Commission became concerned with accounting for interest cost when it noted an increase in the number of nonutility registrants that were adopting a policy of capitalizing interest as part of the cost of certain assets. On June 21, 1974, the SEC issued a release that proposed a moratorium on adoption or extension of a policy of capitalizing interest by registrants other than public utilities that had not, as of June 21, 1974, publicly disclosed such a policy. On November 14, 1974, the moratorium was imposed by ASR No. 163, *Capitalization of Interest by Companies Other Than Public Utilities*. "Public utilities" was defined to include electric, gas, water, and telephone utilities; registrants covered by AICPA Guides *Accounting for Retail Lands Sales* and *Audits of Savings and Loan Associations* were also excluded from the moratorium. In explaining its action, the SEC noted 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, including the development of systematic criteria as to when, if ever, capitalization of interest is desirable.
>
> Accordingly, the Commission concludes that companies other than electric, gas, water and telephone utilities and those companies covered by the two exceptions in the authoritative literature described above which had not, as of June 21, 1974, publicly disclosed an accounting policy of capitalizing interest costs shall not follow such a policy in financial statements filed with the Commission covering fiscal periods ending after June 21, 1974. At such time as the Financial Accounting Standards Board develops standards for accounting for interest cost, the Commission expects to reconsider this conclusion. Until such time, companies which have publicly disclosed such a policy may continue to apply it on a consistent basis but not extend it to new types of assets. Return on equity invested shall not be capitalized by companies other than electric, gas, water and telephone utilities.

The Release amended *Regulation S-X* to require the disclosure of certain information by registrants continuing to capitalize interest.

27. At its meeting on September 18, 1974, the FASB's Advisory Council agreed that this matter should be considered by the FASB, and on November 25, 1974, the Board added the project to its technical agenda. In September 1975, a task force of 16 persons from academe, the financial community, industry, and public accounting was appointed to provide counsel to the Board in preparing a Discussion Memorandum.

28. The project began with a broad scope. It was to deal not only with accounting for interest on debt, but also to explore the proposal to give comprehensive accounting recognition to an

imputed interest cost for equity capital. According to proponents of that proposal, accounting should recognize such imputed interest whether it is to be capitalized or not. The total of debt interest and imputed equity interest, they believe, should be allocated to enterprise assets and operations, just as material, labor, and overhead costs are presently allocated. However, as the project proceeded, the Board came to the conclusion that, because it could involve fundamental changes in the measurement of earnings and asset values—a subject that properly belongs in the Board's conceptual framework project—the Statement resulting from the interest cost project should not deal with that proposal. Accordingly, the scope of the project was narrowed to focus on accounting alternatives that are found in practice under the present accounting model.

29. Presently, some companies account for interest on debt as an expense of the period in which it is incurred. Some companies, on the other hand, capitalize interest on debt as part of the cost of certain kinds of assets, such as construction work in progress, land held for future development, and real estate in process of development; and some companies, notably public utility companies, capitalize a cost of equity funds as well as interest on debt as part of the cost of certain assets. Thus, the basic issue to be resolved by this project was stated in the Discussion Memorandum, *Accounting for Interest Costs*, to be a determination as to which of those accounting alternatives should be applied.

30. In addition to presenting arguments for and against each of the accounting alternatives, the Discussion Memorandum identified 10 implemental issues relating to interest capitalization and three implemental issues relating to information disclosures and application of this Statement. A chapter was devoted to the proposal for comprehensive accounting recognition of imputed equity interest to assist the reader to relate the basic issue being considered to the broader aspects of the subject but, because of the Board's decision not to deal with the proposal at the present time, the related issues were described as "advisory" issues.

31. The Board issued the Discussion Memorandum on December 16, 1977 and held a public hearing in New York on April 4 and 5, 1978. The Board received 145 position papers, letters of comment, and outlines of oral presentations in response to the Discussion Memorandum, and 18 presentations were made at the public hearing.

32. An Exposure Draft of a proposed Statement on *Capitalization of Interest Cost* was issued on December 15, 1978. The Board received 269 letters of comment in response to the Exposure Draft.

Appendix B: BASIS FOR CONCLUSIONS

33. This appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement, including various alternatives considered and reasons for accepting some and rejecting others. Individual assenting Board members gave greater weight to

some factors than to others.

Scope

34. Some respondents to the Discussion Memorandum recommended that regulated enterprises be exempt from the provisions of this Statement because the rate-making process creates a special set of circumstances and because most regulatory agencies prescribe when and how interest shall be capitalized by companies subject to their jurisdiction. The Board concluded that the applicability of this Statement should not differ from that of other FASB Statements. Moreover, the effect of the rate-making process on accounting and reporting by regulated enterprises is the subject of another project on the Board's technical agenda, and the Board concluded that this Statement should not prejudge the outcome of that project.

35. Some respondents to the Exposure Draft urged that the scope of this Statement be expanded to include other costs, such as insurance and property taxes, that are sometimes capitalized in the same circumstances as interest cost. The Board did not adopt that suggestion because special considerations apply to interest cost and expansion of the scope of this Statement at that stage would have significantly delayed its issuance. The scope of the project was considered at length during the Discussion Memorandum stage, as indicated in Appendix A.

The Accounting Alternatives

36. As indicated in Appendix A, the Board considered three basic methods of accounting for interest cost:

a. Account for interest on debt as an expense of the period in which it is incurred.
b. Capitalize interest on debt as part of the cost of an asset when prescribed conditions are met.
c. Capitalize interest on debt and imputed interest on stockholders' equity as part of the cost of an asset when prescribed conditions are met.

The Board concluded that the second of those methods should be adopted. The reasons for that conclusion are presented in paragraphs 37-57.

Interest as a Cost of Acquiring an Asset

37. The Board determined that the primary question to be addressed was whether there are any circumstances in which interest cost should be considered to be part of the historical cost of *acquiring* an asset. The focus on the historical cost of acquiring an asset followed from the Board's decision, in developing the scope of this project, that the accounting alternatives that would be considered for this Statement should be limited to those found in practice based on the present accounting model, as stated in Appendix A. In the present accounting model, nonmonetary assets are generally carried at acquisition cost or some unexpired or unamortized portion of it.[6] The cost "at which assets are carried and expenses are measured in financial

accounting today usually means historical or acquisition cost because of the conventions of initially recording assets at acquisition cost and of ignoring increases in assets until they are exchanged (the realization convention)."[7]

38. Some believe that interest should be capitalized as a cost of holding assets, but, in general, in the present accounting model, costs are not added to assets subsequent to their readiness for use. Consideration of that proposal would require a comprehensive reexamination of a fundamental principle underlying present practice. One of the consequences of restricting the focus to acquisition cost was that capitalization of interest as a holding cost was rejected. Thus, earning assets and nonearning assets not undergoing the activities necessary to get them ready for use do not qualify for interest capitalization under this Statement.

39. The Board concluded that interest cost is a part of the cost of acquiring an asset if a period of time is required in which to carry out the activities necessary to get it ready for its intended use. In reaching this conclusion, the Board considered that the point in time at which an asset is ready for its intended use is critical in determining its acquisition cost. Assets are expected to provide future economic benefits, and the notion of expected future economic benefits implies fitness for a particular purpose. Although assets may be capable of being applied to a variety of possible uses, the use intended by the enterprise in deciding to acquire an asset has an important bearing on the nature and value of the economic benefits that it will yield.

40. Some assets are ready for their intended use when purchased. Others are constructed or otherwise developed for a particular use by a series of activities whereby diverse resources are combined to form a new asset or a less valuable resource is transformed into a more valuable resource. Activities take time for their accomplishment. During the period of time required, the expenditures for the materials, labor, and other resources used in creating the asset must be financed. Financing has a cost. The cost may take the form of explicit interest on borrowed funds, or it may take the form of a return foregone on an alternative use of funds, but regardless of the form it takes, a financing cost is necessarily incurred. On the premise that the historical cost of acquiring an asset should include all costs necessarily incurred to bring it to the condition and location necessary for its intended use, the Board concluded that, in principle, the cost incurred in financing expenditures for an asset during a required construction or development period is itself a part of the asset's historical acquisition cost.

41. Some assenting Board members believe that the informational value of historical cost as an indicator of an asset's cash flow potential is also a reason for capitalizing interest cost. At the time of the decision to acquire an asset, they point out, the enterprise believes that the present value of its cash flow service potential is at least as great as the sum of the costs that will have to be incurred to acquire it. Otherwise, the enterprise presumably would not acquire the asset. Accordingly, the enterprise's commitment of cash or other resources to acquire the asset provides the best available objective evidence of an asset's cash flow service potential at the time of acquisition.

42. Those Board members believe acquisition cost provides the most reliable measure of cash flow potential when assets are self-constructed or produced as well as when they are purchased in arms-length transactions. Measuring the acquisition cost of a self-constructed or produced asset is not as simple as measuring the acquisition cost of a purchased asset, but, those Board members believe, the objective should be the same—to obtain a measure of cash flow service potential that is supported by objective evidence. For such assets, therefore, acquisition cost should include all the cost components envisioned by the enterprise as being necessary to acquire the asset. The cost of financing the asset during the period of its construction or production is one of those cost components. Since the cash flow potential of an enterprise's assets is significant information in assessing the future net cash flows of the enterprise and hence the prospective cash receipts of investors and creditors,[8] a measure of acquisition cost that includes interest cost is likely to be more useful to investors and creditors than one that does not.

43. Some assenting Board members believe that a case could be made for allocating interest cost to all nonmonetary assets, whether being developed for use or in use. It could be argued that, since assets are *future* economic benefits, the historical cost of an asset at any point in time should be the unexpired portion of *all* costs incurred in relation to the asset prior to that time. All assets require financing, and therefore the cost of financing (interest) should be included in the historical cost of all nonmonetary assets. Those Board members, however, concluded that allocation of interest cost to assets in use or ready for use is not appropriate at present. The broad issue of dividing the long-term service potential of an asset into the services associated with periods of use would have to be reexamined before such an extension of the historical cost concept could be made. Further, allocation of interest cost to all nonmonetary assets often would have a relatively small effect on periodic earnings because the amount of interest capitalized in a period would tend to be offset by amortization of interest capitalized in prior periods. The incremental informational benefit would not be commensurate with the additional accounting and administrative costs. They concluded that interest cost should be capitalized only when it is part of the original acquisition cost of an asset.

44. The reasoning in the foregoing paragraphs would lead to the conclusion that interest should be included in the acquisition cost of all assets that are derived from a production, construction, or other time-consuming development process. However, in considering the circumstances in which interest capitalization should be required, the Board weighed the expected benefit in terms of information about enterprise resources and earnings against the expected cost of providing that information. With that consideration in mind when developing the Exposure Draft, the Board had concluded that interest should not be included in the cost of manufactured inventories that turn over relatively quickly and that interest capitalization should be confined to assets whose required development period is significant. But respondents to the Exposure Draft identified a number of problems with the proposal to delineate qualifying assets by the length of the development period. In particular, it was pointed out that a judgment about the benefit of interest capitalization in a given set of circumstances should focus on the significance of the amount of interest cost associable with an asset, and that the length of the development period is only one of the factors to be considered. Other factors include the amount

of expenditures, the timing of expenditures, the capitalization rate, and the criterion by which significance is judged (e.g., periodic earnings). In addition, some respondents said that a review of their operations showed that, in any given year, a very large number of assets would meet the "significant period" test. They said that considerable costs would be involved in continually identifying assets that meet the test and the borrowings to be associated with each asset, and in additional recordkeeping.

45. Other respondents expressed concern that inventory items that require an extended maturation period (such as aging whiskeys and tobacco) would qualify for interest capitalization according to the Exposure Draft. They said that aging is not part of the production process. Moreover, such inventories are often accounted for on the last-in, first-out basis (LIFO), which would present special difficulties in concept, in implementation, and in application of "LIFO conformity" requirements for income tax purposes. Finally, it was observed that, although an individual batch of whiskey or tobacco may be held in inventory for a significant period, there is a constant flow of product into and out of inventory. Hence, the effect on earnings of capitalizing interest on maturing inventories usually would not be significant in the long run.

46. In the light of respondents' comments, the Board decided that cost/benefit considerations indicated that the circumstances in which interest capitalization is required should be more restricted than those set forth in the Exposure Draft and that those circumstances should be delineated by criteria other than the length of the required development period. The significance of the effect of interest capitalization in relation to enterprise resources and earnings is the most important consideration in assessing its benefit. The ease with which qualifying assets and related expenditures can be separately identified and the number of assets subject to interest capitalization are important factors in assessing the cost of implementation. Interest capitalization should be required only when the balance of the informational benefit and the cost of implementation is favorable. The Board judged that a favorable balance is most likely to be achieved where an asset is constructed or produced as a discrete project for which costs are separately accumulated and where construction of the asset takes considerable time, entails substantial expenditures, and hence is likely to involve a significant amount of interest cost. A favorable balance is unlikely in the case of inventory items that are routinely manufactured or otherwise produced in large quantities on a repetitive basis. Accordingly, this Statement proscribes interest capitalization on those types of inventories and provides for interest capitalization on assets that are constructed or produced as discrete projects. (Some Board members believe that another reason for not capitalizing interest on inventories generally is that, because variations presently exist in the methods of costing inventories, inclusion of interest cost would do little to improve comparability of inventory costs among enterprises.)

47. The Board recognized that, in many cases, the effect of interest capitalization and its subsequent amortization or other disposition, compared with the effect of charging it to expense when incurred, would not be material. Some assenting Board members noted that the primary factor in making materiality judgments in current practice usually is the relation to the level or trend of earnings. Accordingly, they anticipate that such a factor will be primary in making

materiality judgments about the requirement for interest capitalization in accordance with this Statement.

48. Some respondents to the Discussion Memorandum and the Exposure Draft expressed the view that interest is a unique cost that cannot be allocated to cost objectives in the same way as material, labor, and overhead costs. The Board rejected that view. As explained in paragraph 51, the Board concluded that the cause-and-effect relationship between acquiring an asset and the incurrence of interest cost makes interest cost analogous to a direct cost that is readily and objectively assignable to the acquired asset. The Board believes that failure to capitalize the interest cost associated with the acquisition of qualifying assets improperly reduces reported earnings during the period of acquisition and increases reported earnings in later periods.

The Amount of Interest Cost to Be Capitalized

49. Some Board members believe that there is a valid conceptual argument for measuring the cost of financing acquisition of qualifying assets on the basis of the enterprise's cost of capital, which would include imputed interest on equity capital as well as interest on borrowed capital. Such a measure would recognize that both borrowed capital and equity capital provide funds to the enterprise and that, due to the fungible nature of cash, it is usually impossible to determine objectively the proportion of the funds expended for a particular purpose that was derived from each source. It would also recognize the interrelationship between an enterprise's cost of borrowing and its cost of equity. Some assenting Board members believe that it may be appropriate at some time in the future to consider whether the cost of equity capital should be recognized within a framework for financial reporting that continues to be based primarily on historical cost. Accordingly, they think that the standards prescribed in this Statement should not be incompatible with that possible development. Other assenting Board members do not share that view. Nevertheless, all Board members agreed that recognition of the cost of equity capital does not conform to the present accounting framework. In the present accounting framework, the cost of a resource is generally measured by the historical exchange price paid to acquire it. However, funds are an unusual resource in that, although an enterprise obtains funds from various sources, only borrowed funds give rise to a cost that can be described as a historical exchange price. Although a historical exchange transaction may occur when equity securities are issued, that transaction is not the basis generally advocated for measuring the cost of equity capital. It is generally agreed that use of equity capital entails an economic cost, but in the absence of a historical exchange price, the cost of equity capital is not reliably determinable. The Board concluded, therefore, that the cost of financing expenditures for a qualifying asset should be measured by assigning to the asset an appropriate portion of the interest cost incurred on borrowings during the period of its acquisition. (As a result of that conclusion, the issue presented in the Discussion Memorandum regarding the appropriate method of accounting for the credit corresponding to imputed interest on equity capital did not have to be addressed.)

50. The Board considered several methods of determining the amount of interest cost to be capitalized. Some suggested that the amount capitalized be limited to the interest incurred on

specific borrowings associated with the qualifying asset by the enterprise. However, in the Board's view, association of sources and uses of funds is primarily subjective. If that suggestion had been adopted, the enterprise's identification of the source of the funds used for the asset would determine not only the amount of interest capitalized but also whether *any* interest is capitalized. Some suggested that interest cost be allocated to qualifying assets on a basis such as total assets or the total of debt and owner's equity. That method would be based on an assumption that funds used for all assets are obtained from borrowings and other sources proportionately. However, in many cases, it would result in an amount of capitalized interest that was unrealistically low as a measure of the economic cost of financing acquisition of the qualifying asset.

51. The Board concluded that the amount of interest cost to be capitalized should be the amount that theoretically could have been avoided during the acquisition period if expenditures for the asset had not been made. Clearly, interest cost can be avoided by repaying existing borrowings as well as by not borrowing additional funds. When an enterprise is contemplating investment in an asset, both those alternatives are available. When the decision to invest in the asset is made, those alternatives are rejected and the incurrence of interest cost during the acquisition period is a consequence of that decision. That cause-and-effect relationship between the investment in the asset and the incurrence of interest cost makes interest cost analogous to a direct cost in those circumstances. Also, the amount of interest cost that could have been avoided is one measure of the opportunity cost incurred. Admittedly, investment of funds in the asset also entails rejection of a wide range of other possible uses of funds, and therefore interest cost avoided is only one of several possible measures of opportunity cost. But it is the measure that can be recognized in the present accounting framework. (In adopting the notion of interest on borrowings as an avoidable cost, the Board does not intend that the practicability of repaying individual borrowings has to be considered.)

52. In the Exposure Draft, the Board proposed a method of associating interest on borrowings with qualifying assets that gave priority to recent borrowings. Respondents criticized that method on a number of grounds, most of which related to its complexity in practice and hence the cost of implementation. The Board concluded that the method should be simplified in order to reduce that cost. Two methods considered were (a) a general measure of the current cost of money, such as the prime rate and (b) the enterprise's incremental borrowing rate. However, the Board rejected those methods on the grounds that the historical exchange price convention requires that the interest rate used for capitalization purposes be based on rates actually being paid by the enterprise. The Board also considered a weighted average of the rates being paid on all borrowings. But it concluded that, despite the element of subjectivity, if an enterprise borrows additional funds with the intention of using them to finance a qualifying asset, the enterprise should not be prevented from using the rate on that borrowing as a capitalization rate. That rate would provide a readily determined measure of a major part of the interest cost that could have been avoided if funds had not been invested in the asset. This Statement therefore permits use of the rate(s) on specific new borrowing(s) associated with a qualifying asset and provides that an average rate shall be applied to expenditures not covered by specific new

borrowings. Judgment is to be used in determining the borrowings on which the average rate is based. Thus, for example, depending on the facts and circumstances, it might be appropriate to include all borrowings of the parent company and consolidated subsidiaries or to include only the borrowings of the corporate entity constructing the qualifying asset. It should be noted, however, that the provisions regarding capitalization rates are intended to allow an enterprise to determine a relevant measure of the cost of financing acquisition of the asset while minimizing the cost of implementing this Statement. Exclusion of borrowings from the computation of the average rate is not to circumvent the requirement to capitalize interest cost to the extent that interest cost has been incurred during a qualifying asset's acquisition period.

53. Some respondents to the Exposure Draft observed that, by attaching an interest cost to all of the expenditures for a qualifying asset, the prescribed method of determining the amount of interest capitalized in effect imputes an interest cost to any equity funds that may have been used. Board members' responses to that observation differ. Some would agree, arguing that the prescribed method uses the cost of borrowings as a surrogate measure of enterprise cost of capital. In their view, the prescribed method is an appropriate compromise between the conceptually desirable and the constraints of the present accounting framework. Other Board members do not share that view. They believe that the essence of this Statement is that interest on borrowings is a cost, which, like any other cost, is capitalizable in certain circumstances. In their view, the notion of interest on borrowings as an avoidable cost incurred as a consequence of the decision to acquire the qualifying asset supports the position that the capitalization method does not impute a cost to equity funds.

54. Some respondents to the Discussion Memorandum and to the Exposure Draft observed that limiting capitalized interest to interest on borrowings would preclude the "all-equity" enterprise from capitalizing interest, even though it incurs an economic cost of the same order as an enterprise that has borrowed funds. The Board concluded that, despite that consequence, capitalization of interest on borrowings in the circumstances specified in this Statement is preferable to the alternatives of (a) excluding interest from asset acquisition cost in all circumstances or (b) imputing interest on equity capital. In the Board's view, the fact that the present accounting framework does not recognize all economic costs should not control accounting for the costs that are recognized. Moreover, an "all-equity" enterprise is not the same as an enterprise that has borrowed funds. (Similarly, an enterprise that is making substantial expenditures for asset construction differs from one that is not.) Those who assert that comparability among enterprises would be greater if all interest cost were expensed would create an illusion of comparability that may disguise the differences in facts.

55. Some respondents disagreed with the conclusion in the Exposure Draft that the total amount of interest cost available for capitalization should be the amount recognized in the present accounting framework and hence include interest cost imputed on certain types of payables in accordance with Opinion 21 and interest cost related to a capital lease determined in accordance with Statement 13. In their view, interest cost determined in accordance with Opinion 21 and Statement 13 clearly relates to transactions other than the acquisition of

qualifying assets. However, as previously indicated, the Board's conclusions in this Statement rest on an assumption that association of sources and uses of funds is primarily subjective. The Board believes that, just as association of a particular borrowing with a qualifying asset is an insufficiently objective basis for determining whether any interest cost should be capitalized, the form of financing transactions covered by Opinion 21 and Statement 13 is an inadequate basis for excluding interest cost recognized on those transactions from the pool of interest cost available for capitalization.

56. The Board concluded that, in determining the expenditures with which interest cost is associated, amounts corresponding to liabilities on which interest cost is not recognized (such as trade payables, accruals, and retainages) should be excluded. The Board does not intend that enterprises try to determine precisely when those liabilities are liquidated. Capitalized costs may be used as a reasonable approximation of expenditures unless the difference is material.

57. One of the issues raised in the Discussion Memorandum was whether capitalized interest should be compounded. The Board concluded that compounding is conceptually consistent with its conclusion that interest on expenditures for the asset is a cost of acquiring the asset. Admittedly, some portion of the interest incurred during an accounting period may be unpaid at the end of the period, but that complication usually may be ignored to simplify practical application.

The Capitalization Period

58. The capitalization period is determined by the definition of the circumstances in which interest is capitalizable. Essentially, the capitalization period covers the duration of the activities required to get the asset ready for its intended use, provided that expenditures for the asset have been made and interest cost is being incurred. Interest capitalization continues as long as those activities and the incurrence of interest cost continue. The capitalization period ends when the asset is substantially complete and ready for its intended use. The words "substantially complete" are used to prohibit continuation of interest capitalization in situations in which completion of the asset is intentionally delayed. For example, it is customary for a condominium developer to defer installation of certain fixtures and fittings until units are sold, so that buyers may choose the types and colors they want. An intentional delay of that kind is related more to marketing of the asset than to the exigencies of the asset acquisition process. Similarly, interest is not to be capitalized during periods when the enterprise intentionally defers or suspends activities related to the asset. Interest cost incurred during such periods is a holding cost, not an acquisition cost. However, delays that are inherent in the asset acquisition process and interruptions in activities that are imposed by external forces are unavoidable in acquiring the asset and as such do not call for a cessation of interest capitalization. Brief interruptions may be disregarded on immateriality grounds.

59. Some respondents to the Exposure Draft asked for confirmation that interest capitalization is not restricted to times when physical change is taking place. Most cited the example of land

development. Many activities, they pointed out, must be undertaken before work on the land itself can begin. In response to those requests, an explanation that the term *activities* is to be construed broadly in this context has been included in paragraph 17.

60. Some respondents to the Exposure Draft asked for clarification concerning the end of interest capitalization when an asset is completed in parts and the individual parts are capable of being used while work continues on other parts. Paragraph 18 now explains that interest capitalization stops on each part as it is completed.

61. Some respondents took issue with the conclusion in Appendix C to the Exposure Draft that interest capitalization on mineral interests should stop when the first well capable of producing oil or gas is completed. They argued that the oil or gas producing system is not ready for its intended use until the means of transporting the oil or gas from the well (e.g., a pipeline) is in place. The Board agreed, and that conclusion has been added to paragraph 18.

62. Some respondents to the Discussion Memorandum expressed the view that capitalization of interest for an asset intended for sale should end when the accumulated costs of the asset equal its net realizable value. The Board concluded that that view is inconsistent with the conclusion that interest is a cost of acquiring the asset. Capitalization of material, labor, and overhead costs does not end when a net realizable value limit is reached; interest cost should not be treated differently. The present accounting requirements for recognizing a lower asset value than acquisition cost should apply when total asset cost includes capitalized interest and when it does not.

Disposition of Capitalized Interest

63. Some companies that presently capitalize interest amortize it over a shorter period than the life of the related asset. The Board believes that the conclusion that interest is part of the cost of acquiring a qualifying asset requires that capitalized interest should not be accounted for differently from other components of asset cost.

Disclosures

64. Disclosure of the total amount of interest cost incurred in an accounting period is required because lenders, security analysts, and others may wish to know that amount in order to compute certain fixed-charge coverage ratios, etc. The amount of interest cost incurred and capitalized during a period is required because that amount is not included in the determination of earnings.

65. The Board concluded that the other possible disclosures listed in the Discussion Memorandum were not required. Descriptions of the method of accounting for interest, the circumstances in which interest is capitalized, and the method of determining the amount of interest capitalized are unnecessary because those matters are dealt with in this Statement. Information about amortization of capitalized interest is unnecessary; such disclosure is not

required for other components of asset cost.

66. Some respondents to the Discussion Memorandum suggested that the net effect on periodic earnings of capitalizing interest as opposed to charging it to expense should be disclosed. The Board decided that such disclosure was unnecessary once accounting alternatives had been eliminated.

Effective Date and Transition

67. The Board concluded that this Statement should be applied prospectively. Inevitably, prospective application of a Statement entails some impairment of comparability among enterprises' financial statements during the periods immediately following its adoption. Retroactive application in this instance, however, would require greater accounting effort than would be justified by the resulting informational benefits.

Footnotes

FAS34, Footnote 1--Interest cost on these obligations includes amounts resulting from periodic amortization of discount or premium and issue costs on debt.

FAS34, Footnote 2--Securities and Exchange Commission, ASR No. 163, *Capitalization of Interest by Companies Other Than Public Utilities* (Washington: November 14, 1974).

FAS34, Footnote 3--The term *intended use* embraces both readiness for use and readiness for sale, depending on the purpose of acquisition.

FAS34, Footnote 4--See paragraph 17 for a definition of those activities for purposes of this Statement.

FAS34, Appendix A, Footnote 5--In 1917, the American Institute of Accountants (as it was then known) set up a Special Committee on Interest in Relation to Cost. The Committee concluded that interest on investment should not be included in production cost. At the Institute's 1918 annual meeting, the members in attendance voted their acceptance and approval of the Committee's report. Although the vote of the Institute's membership is of historical interest, it has not been incorporated into the body of authoritative pronouncements currently in force.

FAS34, Appendix B, Footnote 6--APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, par. 163.

FAS34, Appendix B, Footnote 7--Ibid., par. 164.

FAS34, Appendix B, Footnote 8--FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, especially par. 37.