Statutory Issue Paper No. 44

Capitalization of Interest

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 44

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance does not address capitalization of interest cost.

2. GAAP guidance allows capitalization of interest as part of the historical cost of acquiring certain assets.

3. The purpose of this issue paper is to establish statutory accounting principles for capitalization of interest cost that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Under statutory accounting principles, the historical cost of acquiring an asset generally includes the necessary costs incurred to bring it to the condition and location necessary for its intended use. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset shall be included as a part of the historical cost of acquiring the asset.

5. Interest cost shall be capitalized for the following types of assets:

a. Assets 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. real estate developments);

c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The equity method is defined in *Issue Paper No. 46—Accounting for*

Drafting Notes/Comments

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.

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.

15. FAS 42 provides the following guidance:

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment to FASB Statement No. 34

4. The last two sentences of paragraph 8 of Statement 34 are superseded and replaced by the following sentence:

> Accordingly, interest shall not be capitalized in the situations described in paragraph 10.

The introduction of paragraph 9 of Statement 34 is amended to read as follows:

> Interest shall be capitalized for the following types of assets ("qualifying assets"):

Effective Date and Transition

5. This Statement shall be effective for fiscal years beginning after December 15, 1979. The provisions of this Statement shall be applied at the same time as the provisions of Statement 34 are first applied. Enterprises that already have adopted the provisions of Statement 34 shall apply the provisions of this Statement in their next fiscal year beginning after October 15, 1980 and may, but are not required to, restate their financial statements for the year of initial adoption to reflect the provisions of this Statement.

16. FAS 58 provides the following guidance:

INTRODUCTION

1. The FASB has received several inquiries concerning (a) the limitations of FASB Statement No. 34, Capitalization of Interest Cost, relating to capitalization of interest cost in situations involving investees accounted for by the equity method and (b) the inconsistent requirements between (i) the limitations of Statement 34 on the capitalization of interest cost in situations involving investees accounted for by the equity method and (ii) the requirement of APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock, that income and owners' equity amounts should be the same whether a subsidiary is consolidated or accounted for by the equity method.

2. The basic issue is whether Statement 34 distinguishes qualifying assets owned by the parent and consolidated subsidiaries from those owned by unconsolidated subsidiaries, joint ventures, and other investees accounted for by the equity method for purposes of determining the amount of interest cost to be capitalized in the investor's financial statements. Although paragraph 15 of Statement 34 clearly limits the amount of interest available for capitalization in consolidated financial statements to that shown in those statements, neither paragraph 9 nor paragraph 15 of Statement 34 is explicit regarding any similar limitations on qualifying assets.

3. The Board has concluded that qualifying assets as described in Statement 34 are limited

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to FASB Statement No. 34

5. The following subparagraph is added to paragraph 9 of Statement 34, which specifies the qualifying assets for which interest is to be capitalized:

> c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations.

6. The following subparagraphs are added to paragraph 10 of Statement 34, which specifies the types of assets for which interest is not capitalized:

> c. Assets that are not included in the consolidated balance sheet of the parent company and consolidated subsidiaries
>
> d. Investments accounted for by the equity method after the planned principal operations of the investee begin
>
> e. Investments in regulated investees that are capitalizing both the cost of debt and equity capital

7. The following sentence is added to paragraph 20 of Statement 34, which specifies the accounting for interest after it is capitalized:

> Interest capitalized on an investment accounted for by the equity method shall be accounted for in accordance with paragraph 19.b. of Opinion 18 which states: "A difference between the cost of an investment and the amount of underlying equity in net assets of an investee should be accounted for as if the investee were a consolidated subsidiary."

Amendments to Other Pronouncements

8. Paragraph 10 of *ARB No. 51, Consolidated Financial Statements*, requires accounting for a subsidiary on a step-by-step basis if control is obtained through purchase of two or more blocks of stock. Paragraph 19.m. of Opinion 18 requires retroactive adjustment for an investee that was previously accounted for on other than the equity method when that investee becomes qualified for use of the equity method. Paragraph 34 of *APB Opinion No. 20, Accounting Changes*, requires restatement of prior financial statements for changes in reporting entities. The following footnote is added to each of those paragraphs:

> The amount of interest cost capitalized through application of *FASB Statement No. 58, Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, shall not be changed when restating financial statements of prior periods.

Effective Date and Transition

9. This Statement shall be effective for investments made after June 30, 1982 except that investments contracted for but not yet made may be accounted for as specified in the next sentence. Investments existing at the effective date or date of earlier adoption of this Statement (a) may be accounted for according to the provisions of this Statement or (b) may continue to be accounted for by the method of interest capitalization previously used even though not in accordance with the provisions of this Statement. Earlier application is encouraged. This Statement may be applied retroactively for annual financial statements that have not been issued but shall not be applied retroactively for previously issued annual financial statements.

17. FAS 62 provides the following guidance:

INTRODUCTION

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