Statement of Financial Accounting Standards No. 58

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Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method

(an amendment of FASB Statement No. 34)

April 1982

Financial Accounting Standards Board
of the Financial Accounting Foundation
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an amendment of FASB Statement No. 34

FAS 58 Summary

This Statement amends FASB Statement No. 34, *Capitalization of Interest Cost,* (1) to limit capitalization of consolidated interest cost to qualifying assets of the parent company and consolidated subsidiaries and (2) to include investments (equity, loans, and advances) accounted for by the equity method as qualifying assets of the investor 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. This Statement does not affect the accounting for and reporting of capitalized interest cost in the separate financial statements of investees.

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 to those of the parent company and consolidated subsidiaries. The Board has also concluded that certain investments (equity, loans, and advances) accounted for by the equity method are qualifying assets of the investor (including parent company and consolidated subsidiaries). For the investment to be a qualifying asset, the investee must be undergoing activities in preparation for its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investment ceases to be a qualifying asset when those operations begin. Subsequent accounting for interest capitalized on the investment is specified by paragraph 19(b) of Opinion 18.

4. This Statement does not affect the accounting for and reporting of capitalized interest cost in the separate financial statements of investees.

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.

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 are not persuaded by the arguments in this Statement that an investor should consider an investment in certain types of investees accounted for by the equity method as a qualifying asset for purposes of applying Statement 34. They see merit in an approach that would permit the inclusion of the qualifying assets of the investee in the qualifying assets of the entity (parent company and consolidated subsidiaries) issuing consolidated financial statements. However, they are convinced that there are serious complications in application of such an approach (paragraph 19). They also acknowledge the validity of the argument (paragraph 11) that there is a fundamental distinction between (a) the individual assets acquired by subsidiaries that are considered to be an integral part of the entity issuing consolidated financial statements and (b) the individual assets acquired by other investees that are excluded from consolidated financial statements. Therefore, they favor an interpretation of Statement 34 that, for future transactions, consolidated interest should not be capitalized on the qualifying assets of investees accounted for by the equity method. They note that the investee is subject to Statement 34 and will capitalize its own interest on qualifying assets.

Members of the Financial Accounting Standards Board:

Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

10. As stated in paragraph 1, the Board 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.

11. Some believe that Statement 34 proscribes capitalization of consolidated interest cost on qualifying assets of investees accounted for by the equity method. They believe that there is a fundamental distinction between (a) the individual costs incurred and assets acquired by subsidiaries that are considered to be an integral part of the entity issuing consolidated financial statements and (b) the individual costs incurred and assets acquired by other investees that are excluded from consolidated financial statements. They believe that the individual assets, liabilities, revenues, and expenses reflected in consolidated financial statements should relate to only the entity defined by those consolidated statements (that is, to only the parent company and consolidated subsidiaries) and should be complete. They believe that the equity method of accounting for investees appropriately reflects only the consolidated entity's net investment in and share of net income of the investee. Otherwise, users cannot use the amounts reported in the consolidated financial statements for their assessments of financial trends and relationships of the consolidated economic entity (for example, sales, gross profit percentages, current ratios, returns on total assets, etc.). Those who would proscribe capitalization of consolidated interest cost on qualifying assets of investees accounted for by the equity method do not believe that Opinion 18 precludes differences in net income and owners' equity, depending on whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated.

12. Others believe that Statement 34 properly does not distinguish between qualifying assets of the investor (parent company and consolidated subsidiaries) and those of investees accounted for by the equity method. They believe that Opinion 18 generally precludes differences in net income and owners' equity for investees accounted for by the equity method. Accordingly, they believe both qualifying assets and interest cost of all

investees accounted for by the equity method should be included in the application of Statement 34. They believe that consistent application of Opinion 18 is necessary because changes in the form of a transaction could otherwise affect the amount of interest capitalized. For example, the amount of interest capitalized could be affected because of either differences in interest rates or amounts eliminated in preparation of the investor's financial statements if the parent were to borrow and lend to the investee instead of the investee's borrowing directly from an independent third party with the parent company's guarantee.

13. Still others believe that investments (equity, loans, and advances) in investees that have not begun their planned principal operations are qualifying assets. They believe those investments meet the intent of paragraph 7 of Statement 34 (which states that 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) because the investor's funds have been invested in an asset that is not ready for its intended use until the investee commences those principal operations. They believe this is particularly evident in the case of projects organized by a limited number of investors to pool resources in developing production or other facilities. Others believe that investments in investees accounted for by the equity method are never qualifying assets because they believe that such investments do not meet the description of qualifying assets in paragraph 9 of Statement 34.

14. An Exposure Draft of a proposed Statement, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*, was issued on September 30, 1981. The Board received 72 letters of comment in response to the Exposure Draft. Certain of the comments received and the Board's consideration of them, including various alternatives considered and reasons for accepting some and rejecting others, are discussed in the remaining paragraphs.

15. Several respondents to the Exposure Draft stated that investments in investees accounted for by the equity method should be considered qualifying assets only to the extent that the investments in the investee have been reinvested in qualifying assets as defined in Statement 34. The Board concluded, for the reasons cited in paragraph 11, above, that qualifying assets as described in Statement 34 should be limited to those of the parent company and consolidated subsidiaries. The Board also concluded that an investment accounted for by the equity method that has not begun its planned principal operations should be a qualifying asset of the investor 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. An investment in an investee that is not undergoing activities necessary to commence planned principal operations is not intended to be a qualifying asset under this Statement. The Board believes these conclusions are consistent with the objectives included in paragraph 7 of Statement 34. The Board believes that consideration of the individual qualifying assets of investees accounted for by the equity method would contradict the rationale in paragraph 11, above, for exclusion from consolidated financial statements of the individual assets and liabilities of such investees.

16. Some respondents stated that including investments in investees accounted for by the equity method in qualifying assets of the investor is undesirable because it would result in an additional exception to paragraph 19

of Opinion 18 that states that net income and stockholders' equity are the same whether an investment in a subsidiary is accounted for under the equity method or the subsidiary is consolidated. The Board realizes that application of Statement 34 and this Statement may produce results that are an exception to paragraph 19 of Opinion 18; that is, consolidated net income and owners' equity may be affected by whether an investee entity is consolidated or accounted for by the equity method. The Board noted the existing exceptions in (a) paragraph 19(i) of Opinion 18 and (b) footnote 5 of FASB Statement No. 12, *Accounting for Certain Marketable Securities*, as establishing circumstances in which net income and stockholders' equity may differ, depending on whether an investment in a subsidiary is accounted for by the equity method or the subsidiary is consolidated. The Board believes paragraph 19 of Opinion 18 provides important general guidance but was not intended to be inviolable in specific circumstances.

17. Some respondents concluded that consolidated interest cost should not be capitalized on the investment in investees accounted for by the equity method. They believe that such investments do not meet the definition of a qualifying asset in Statement 34 because they are not constructed or produced for the consolidated enterprise's own use. The Board has concluded, for reasons cited in paragraphs 11 and 15, above, that the asset that is relevant for determining the qualifying assets of the consolidated group is the investment in the equity method investee until the investee has begun its planned principal operations.

18. Several respondents suggested that subsequent investments in investees that have begun their planned principal operations should qualify for interest capitalization. They believe that allowing capitalization of interest cost on investments in investees accounted for by the equity method that have not begun their planned principal operations while prohibiting capitalization of interest cost on similar investments of an established investee that is undergoing substantial expansion creates a situation in which similar circumstances may be accounted for differently. If an investee has several distinct projects in process and each becomes operational at different times, these respondents believe that allocation of the investment by the investor should be allowed, with capitalization of interest cost taking place on those projects that have not begun their planned principal operations. The Board concluded that the investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

19. Some respondents suggested that the investor should capitalize interest in consolidation on its proportionate share of the equity method investee's average amount of qualifying assets on which the equity method investee has not capitalized interest. The Board considered and rejected this approach because it concluded that (a) the investment in the investee is the qualifying asset for purposes of interest capitalization, (b) only limited guidance is currently available for application of the method, and (c) it involves complex calculations using arbitrary assumptions. The Board recently added to its agenda a project that will consider issues regarding the proportionate method of consolidation and also believes that it would not be prudent to specify a method of accounting that is currently under consideration in a major agenda project and is not clearly defined in current accounting literature.

20. Some respondents asked for clarification of the term when planned principal operations begin to be able to determine when the investment in the investee that is the qualifying asset is "ready for its intended use" and interest capitalization ceases under Statement 34. The Board has used that term in this Statement to have the

same meaning as in FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises.* Statement 7 considers an enterprise to be in the development stage if planned principal operations have not commenced and if it is devoting substantially all of its efforts to establishing a new business through activities such as financial planning; raising capital; exploring for natural resources; developing natural resources; research and development; establishing sources of supply; acquiring property, plant, and equipment or other operating assets, such as mineral rights; recruiting and training personnel; developing markets; and starting up production.

21. Some respondents stated that a form of "double counting" may result if the investor capitalizes interest on its investment in an equity method investee and that investment also includes the investor's share of the investee's earnings (losses) that, in turn, may reflect the investee's own capitalization of interest on its qualifying assets. The Board believes, however, that the interest capitalized by the investee is a cost like any other cost of acquiring a qualified asset and is not reflected in the investee's earnings any differently than those other costs (for example, materials and labor) that are included in acquisition cost rather than deducted as expenses in determining earnings. The Board also believes that in situations involving intercompany interest there should be little effect because capitalized intercompany interest should be eliminated in accordance with Opinion 18 and ARB 51.

22. A few respondents requested guidance regarding application of the proposed Statement to an investment by an investor in a regulated investee that is accounted for by the equity method while the investee is constructing qualifying assets. The regulated investee capitalizes both a cost of debt and a cost of equity capital during its construction period rather than the amount of interest that it would capitalize in accordance with Statement 34. That method imputes a cost to the investee's equity capital and recognizes that cost as part of the carrying amount of the asset under construction and as current earnings of the investee. Since the investor, by recognizing its equity in the investee's current earnings, includes its prorated share of that imputed cost in the carrying amount of its investment and in its current earnings, the investor should not capitalize an additional cost.

23. Some respondents requested clarification regarding the meaning of the term goodwill in paragraph 12 of the Exposure Draft. They suggested that the capitalized interest should be associated with the related assets of the investee and amortized on the basis of the estimated useful lives of those assets. The situation referred to in paragraph 12 of the Exposure Draft was generally limited to one in which the investee would not have underlying qualifying assets. The intent of this Statement is to require capitalization of interest cost on an investment accounted for by the equity method that has not begun its planned principal operations 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. Under those circumstances, capitalized interest cost may be associated with the estimated useful lives of the investee's assets and amortized over the same period as those assets. Interest capitalized on the investments accounted for by the equity method is amortized consistent with paragraph 19(b) of Opinion 18. This Statement therefore does not refer to goodwill.

24. Some respondents requested clarification regarding whether the transition provisions of the Exposure

Draft permitted retroactive application in previously issued financial statements and whether a qualifying investment existing on the effective date may be included in qualifying expenditures. The Board has revised the transition provisions to indicate that retroactive application in previously issued annual financial statements is not permitted and to clarify that an investment existing or contracted for on the effective date or date of earlier adoption (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 for those investments even though not in accordance with the provisions of this Statement. The Board concluded that an investor that made an investment or contracted to do so prior to the effective date of this Statement should not be required to change its method of accounting to conform to the provisions of this Statement.

25. The Board concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 9 are advisable in the circumstances.