Statement of Financial Accounting Standards No. 62

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Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants

(an amendment of FASB Statement No. 34)

June 1982

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

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an amendment of FASB Statement No. 34

FAS 62 Summary

This Statement amends FASB Statement No. 34, *Capitalization of Interest Cost,* (a) to require capitalization of interest cost of restricted tax-exempt borrowings less any interest earned on temporary investment of the proceeds of those borrowings from the date of borrowing until the specified qualifying assets acquired with those borrowings are ready for their intended use and (b) to proscribe capitalization of interest cost on qualifying assets acquired using gifts or grants that are restricted by the donor or grantor to acquisition of those assets.

INTRODUCTION

1. The FASB has received a number of requests to reconsider the issue of offsetting interest income against interest cost in the application of FASB Statement No. 34, *Capitalization of Interest Cost,* for purposes of determining either capitalization rates or limitations on the amount of interest to be capitalized. FASB Technical Bulletin No. 81-5, *Offsetting Interest Cost to Be Capitalized with Interest Income,* states that Statement 34 does not permit such offsetting. Other requests have been received to consider the issue of capitalization of interest cost in situations in which qualifying assets are acquired using gifts and grants restricted to the purchase of the specified assets.

2. The Board has concluded that Statement 34 should be amended to require offsetting of interest income against interest cost in certain circumstances involving tax-exempt borrowings that are externally restricted as specified in paragraph 3. Those situations include many governmental borrowings and most governmentally sponsored borrowings (such as industrial revenue bonds and pollution control bonds). In such situations, interest earned generally is considered in and is significant to the initial decision to acquire the asset, and the capitalization of net interest cost provides a better measure of the entity's net investment in the qualifying

assets. The Board believes that in those circumstances the association is direct and the funds flows from borrowing, temporary investment, and construction expenditures are so intertwined and restricted as to require accounting for the total net cost of financing as a cost of the qualifying assets. The Board also concluded that in all other situations offsetting of interest income against interest cost is not appropriate. The Board further concluded that qualifying assets acquired with externally restricted gifts or grants should not be subject to capitalization of interest cost under Statement 34.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

3. Interest earned shall not be offset against interest cost in determining either capitalization rates or limitations on the amount of interest cost to be capitalized except in situations involving acquisition of qualifying assets financed with the proceeds of tax-exempt borrowings if those funds are externally restricted to finance acquisition of specified qualifying assets or to service the related debt.

4. The amount of interest cost capitalized on qualifying assets acquired with proceeds of tax-exempt borrowings that are externally restricted as specified in paragraph 3 shall be all interest cost of the borrowing less any interest earned on related interest-bearing investments acquired with proceeds of the related tax-exempt borrowings [1] from the date of the borrowing until the assets are ready for their intended use. Interest cost of a tax-exempt borrowing shall be eligible for capitalization on other qualifying assets of the entity when the specified qualifying assets are no longer eligible for interest capitalization.

Amendments to FASB Statement No. 34

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

> f. Assets acquired with gifts and grants that are restricted by the donor or grantor to acquisition of those assets to the extent that funds are available from such gifts and grants. Interest earned from temporary investment of those funds that is similarly restricted shall be considered an addition to the gift or grant for this purpose.

6. The following footnote is added at the end of the first sentence of paragraph 13 of Statement 34, which deals with determining the amount of interest cost to be capitalized:

> *If qualifying assets are financed with the proceeds of tax-exempt borrowings and those funds are externally restricted to the acquisition of specified qualifying assets or to service the related debt, the amount of interest cost capitalized shall be determined in accordance with FASB Statement No. 62, *Capitalization of Interest Cost in Situations*

Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants.

7. The following footnote is added to paragraph 17 of Statement 34, which specifies the period for interest capitalization:

> *In situations involving qualifying assets financed with the proceeds of tax-exempt borrowings that are externally restricted as specified in Statement 62, the capitalization period begins at the date of the borrowing.

Rescission of Technical Bulletin

8. FASB Technical Bulletin No. 81-5, *Offsetting Interest Cost to Be Capitalized with Interest Income,* is rescinded upon issuance of this Statement.

Effective Date and Transition

9. This Statement shall be effective for tax-exempt borrowing arrangements entered into and gifts or grants received after August 31, 1982, with earlier application encouraged in financial statements that have not been previously issued. This Statement may be, but is not required to be, applied retroactively to previously issued financial statements for fiscal years beginning after December 15, 1979. If previously issued financial statements are restated, the financial statements shall, in the year that this Statement is first applied, disclose the nature of any restatement and its effects on income before extraordinary items, net income, and related per share amounts for each restated year presented.

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, Morgan, and Walters dissented.

Mr. Block does not support this standard because it merges the accounting for three dissimilar business activities into one: the borrowing of funds, the temporary investment of funds, and the acquisition of capital assets. Users of financial statements find it useful to calculate rates of return to providers of capital, such as return on equity, return on long-term capital, and return on total capital, as well as returns on various types of investment assets and operating assets. Under this standard, interest income will not be reported as a return on the investment asset, interest expense will not be reported as a return on borrowed funds, and a net amount of interest expense or income will be amortized over the life of a fixed asset as depreciation rather than recognized currently as interest. This obscures information significant to users, particularly to those who look upon depreciation as a return of capital, interest cost as a return on capital, and interest income as a return on a financial asset. In addition, this standard calls for an unwarranted extension of the capitalization period to include a period when no acquisition activities are under way, contrary to two of the three requirements of paragraph 17 of Statement 34. The extension of the capitalization period is defended (paragraphs 2 and 14 of this Statement) on grounds that the investment and financing activities are generally considered in the decision to acquire the asset. Mr. Block believes that accounting should reflect the nature and circumstances of transactions and not the unverifiable motivations and expectations that led to them. He doubts that the deferred net interest credit generated during the preacquisition period meets the definition of any element other than revenue as set forth in FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises,* and is troubled by the possibility that in extreme cases the acquired asset could be carried at a negative cost.

Mr. Morgan and Mr. Walters believe that offsetting related interest income and expense during the acquisition period is appropriate and consistent with the avoidable-interest-cost notion that is embodied in Statement 34. They disagree with this Statement, however, because it restricts offsetting to tax-exempt borrowings. In their opinion, the reasoning for this narrow approach is based on a conclusion that only the tax-exempt situations are so closely intertwined with the asset acquisition as to require association when, in all likelihood, such intertwining may exist regardless of the tax status of the borrowings. In addition, they believe that it is inconsistent to view the borrowings as intertwined with the asset during the capitalization period and as part of the pool of fungible funds from which interest is available for capitalization on other assets after the capitalization period.

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: EXAMPLE OF APPLICATION OF THIS STATEMENT

10. The following example illustrates the application of this Statement in the situation described below:

a. The entity is committed to construct Project A at a cost of $10 million. Project A is to be financed from three sources:
   (1) $4 million government grant restricted to use for the specified construction project, payable $1 million per year
   (2) $4 million tax-exempt borrowing at an interest rate of 8 percent ($320,000 per year)
   (3) $2 million from operations
b. The entity has $10 million in other borrowings that are outstanding throughout the construction of Project A. The interest rate on those borrowings is 6 percent. Other qualifying assets of the entity never exceed $5 million during the construction of Project A.
c. The proceeds from the borrowing and the initial phase of the grant are received 1 year in advance of starting construction on Project A and are temporarily invested in interest-bearing investments yielding 12 percent. Interest income earned from temporary investments is not reinvested.
d. Project A will take 4 years after start of construction to complete.
e. The following table sets forth the amount of interest to be capitalized as part of the entity's investment in Project A.
f. Over the course of construction the net cost of financing is $678,000, the sum of the interest capitalized for the 5 years. Accordingly, the entity's total net investment in Project A will be $10,678,000.

	Year				
	19X1	19X2	19X3	19X4	19X5
	(amounts in thousands)				
(1) Assumed average qualifying assets	$ 0	$2,000	$5,000	$8,000	$9,000
(2) Average funding received					
borrowing	4,000	4,000	4,000	4,000	4,000
grant	1,000	2,000	3,000	4,000	4,000
(3) Average temporary investments ((2) – (1), not less than zero)*					
borrowing	4,000	3,000	1,000	0	0
grant	1,000	1,000	1,000	0	0
(4) Interest earned ((3) x 12 percent)					
(a) borrowing	480	360	120	0	0
(b) grant	120	120	120	0	0
(5) Average qualifying assets in excess of borrowing, grant, and interest earned on grant †	0	0	0	0	640
(6) Interest cost capitalized—other borrowings ((5) x 6 percent)	0	0	0	0	38
(7) Interest cost—tax-exempt borrowings	320	320	320	320	320
(8) Interest capitalized ((6) + (7) – (4)(a)) ‡	(160)	(40)	200	320	358

*Balances of unexpended borrowings and unexpended grants can vary depending on the source from which the entity elects to disburse funds.

†That is, (1) average qualifying assets minus the sum of ((2) average funding received plus (4)(b) cumulative interest earned on grant), not less than zero.

‡ Note that amounts in parentheses are reductions in the cost of the asset.

Appendix B: BASIS FOR CONCLUSIONS

11. An Exposure Draft of a proposed Statement, *Capitalization of Interest Cost in Situations Involving Tax-Exempt Borrowings and Certain Gifts and Grants,* was issued on December 22, 1981. The Board received 94 letters of comment in response to the Exposure Draft. This appendix discusses the factors that the Board considered significant in reaching the conclusions in this Statement. The Board members who assented to this Statement did so on the basis of the overall considerations. Individual Board members gave greater weight to some factors than to others.

Tax-Exempt Borrowings

12. Many respondents recommended that offsetting interest income against interest expense be extended to situations in addition to tax-exempt borrowings. They believe that the tax status of the borrowings should not determine the accounting and that offsetting should be required in situations that involve borrowings that are externally restricted for use on particular projects specified under the terms of the borrowing agreement and that externally restrict the interest on temporary investment of the proceeds to finance construction or service the related debt. They believe that the association of such borrowings with the specified projects is direct and that offsetting is appropriate under those circumstances.

13. Some respondents stated that interest income earned prior to acquisition or construction is related to investment decisions and not to acquisition decisions. They would not offset the interest earned for the period from the date of the borrowing to the beginning of the acquisition period even in situations involving tax-exempt borrowings.

14. Statement 34 requires that interest cost be capitalized only on funds that actually have been expended in the process of acquiring a qualifying asset. Obviously, those expended funds cannot be earning interest income. Identifying a borrowing with a specific acquisition and requiring that interest income be offset against interest cost in determining the amount of interest to be capitalized necessarily involves extending the beginning of the capitalization period from the date actual expenditures are made to the date of the borrowing. The Board does not believe that extending the capitalization period in that way and thereby generally increasing the amount of capitalized interest is appropriate. As stated in paragraph 6 of Statement 34, "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." Borrowing for indeterminate periods in advance of actual expenditures cannot be said generally to be a necessary part of acquiring an asset. The Board is persuaded, however, that an exception should be made in the case of tax-exempt borrowings specified by this Statement. The timing and use of tax-exempt borrowings are generally an integral part of the decision to acquire the related asset, and the net interest cost

from the date of borrowing to the time the acquired asset is substantially complete and ready for its intended use is an essential part of the cost of acquiring that asset.

15. Some respondents questioned the appropriateness of a net reduction in the cost of an asset that may occur if the interest earned from the date of borrowing is greater than the interest accrued on the debt during the capitalization period. The Board believes, for the reasons indicated in paragraph 14, that interest earned on the temporary investment of the proceeds of certain tax-exempt borrowings from the date of borrowing until the specified qualifying assets are ready for their intended use is a part of the net cost of financing that is properly included as a cost of the qualifying asset. This may result in a net reduction in the cost of an asset.

16. Some respondents stated that interest cost of a tax-exempt borrowing should not be eligible for capitalization on other qualifying assets of the entity if the specified qualifying asset is no longer eligible for capitalization. They believe that this conflicts with the notion of specific association between the tax-exempt borrowings and the assets acquired and that the initial association of the borrowing with the qualifying asset nullifies subsequent capitalization of interest cost of the borrowing. The Board believes that the avoidable-interest concept explained in paragraph 12 of Statement 34 requires that interest cost of tax-exempt borrowings be eligible for capitalization on other qualifying assets acquired after completion of the specified qualifying assets. For the same reason, the interest cost on funds provided from the tax-exempt borrowings that are not designated for the acquisition of qualifying assets and servicing the related debt during the capitalization period are eligible for capitalization on other qualifying assets.

Gifts and Grants

17. Nearly all of the respondents who commented on the proposed treatment for qualifying assets acquired with a restricted gift or grant and for interest earned on the temporary investment of those funds supported the Exposure Draft. They believe that qualifying assets acquired with restricted gifts and grants should not be subject to capitalization of interest cost under Statement 34 because they believe there is no economic cost of financing associated with a gift or grant. They believe such an exemption is appropriate only if the gift or grant is restricted by the donor or grantor to the acquisition of the specified asset (or otherwise required to be returned to the donor or grantor). Accordingly, they would capitalize no interest cost during the acquisition of the qualifying asset to the extent that funds are available from such gifts and grants. They would also consider restricted interest earned from temporary investment of the gift or grant as an enhancement to and consequently an integral part of the gift or grant. The Board concurred and has adopted those provisions of the Exposure Draft.

Transition

18. Some respondents requested that the transition provisions of the Exposure Draft be modified to permit retroactive application. They believe that permitting retroactive application would enable enterprises to eliminate problems of lack of comparability resulting from applying

Statement 34 and Bulletin 81-5 that prohibit offsetting and the provisions of this Statement that require offsetting. The Board concurred and has revised the transition provisions to permit retroactive application to the effective date of Statement 34. Statement 34 was effective prospectively for fiscal years beginning after December 15, 1979.

19. 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.

Footnote

FAS62, Footnote 1--The interest cost and interest earned on any portion of the proceeds of the tax-exempt borrowings that are not designated for the acquisition of specified qualifying assets and servicing the related debt are excluded. The entire interest cost on that portion of the proceeds that is available for other uses (such as refunding of an existing debt issue other than a construction loan related to those assets) is eligible for capitalization on other qualifying assets.