SFAS 34: A Recipe for Diversity

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While preparers of financial statements are required to comply with Generally Accepted Accounting Principles, adherence to GAAP, *per se*, is no guarantee that financial statements will fairly represent either the financial position or the results of operations of an enterprise. Preparers of financial statements *must* take into account the qualitative characteristics of the information being presented.

Applying promulgated GAAP should provide like results in like circumstances. To properly serve the users of financial information, standards should both limit diversity in practice, and, at least in part, insure the quality of the information presented. When a standard lacks sufficient internal consistency to meet these expectations, it fails the user and becomes a prime candidate for examination in light of the recently completed Conceptual Framework project.

SFAS 34, "Capitalization of Interest Cost," is such a standard. It lacks sufficient internal consistency to insure that the results of its application will be verifiable and representationally faithful. Consequently, the financial information may lack comparability.

The FASB noted in SFAC 2 that "...in seeking comparability, accountants must not disguise real differences, nor create false differences" [Para. 119]. This article will show that SFAS 34 is structured so as to allow the preparer of financial statements the opportunity to create or disguise differences, intentionally or unintentionally.

THE PURPOSE AND APPLICATION OF THE STANDARD

SFAS 34 was issued in 1979 in response to an SEC moratorium on the capitalization of interest by non-utility firms. Prior to the issuance of the Standard, utility companies routinely capitalized interest costs associated with "self-contructed" assets. The SEC became concerned about the growing lack of comparability as non-utility enterprises also began to adopt the practice.

This Standard settled the issue by requiring all enterprises to capitalize interest on assets which are (a) constructed for the enterprise's own use, or (b) produced as discrete projects which are intended for sale or lease to others [Para. 9]. The Standard refers to these as "qualifying assets."

One objective of requiring that interest be capitalized is "to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset..." [Para. 7]. Traditionally, the historical cost of an asset has included all expenditures required to bring the asset to condition and location necessary for use. The Board took the position that interest is an acquisition cost, and should be included as a part of the asset's historical cost [Para. 6].

The amount of interest included in the asset's cost is a portion of the enterprise's total interest cost incurred during the "capitalization period." The capitalization period begins when expenditures have been made, activities are in progress, and interest cost is being incurred. It continues until the asset is ready for its intended use [Para. 17].

The intent of the Standard is to capitalize the amount of interest that theoretically could have been avoided if expenditures for the asset had not been made. The Standard refers to this as "avoidable interest" [Para. 12]. This theoretically avoidable interest is not limited to the cost associated with new debt used to finance the project. It includes other interest cost that theoretically could have been avoided had the funds expended on the project been used, instead, to extinguish debt.

To determine the amount of avoidable interest, the Standard requires the use of a "capitalization rate." This rate may be a

"specific borrowing rate" (e.g., the rate associated with a construction loan), or a weighted average of the rates associated with the firm's outstanding debt [Para. 13]. The capitalization rate is then applied to the "weighted average accumulated expenditures"—the expenditures weighted for the time they are outstanding during the period.

IDENTIFYING THE PROBLEM

We were alerted to the difficulties in applying this Standard by the change in the computational methods presented in the fourth and fifth editions of Kieso and Wygandt's *Intermediate Accounting*. This change was especially interesting in that essentially the same numerical example was used, but the illustrated solutions had significantly different results.

A review of other intermediate accounting texts revealed that several different computational approaches are being presented.[1] Apparently, depending on one's interpretation, there is more than one "correct" method which can be used to determine the amount of interest to be capitalized.

In attempting to reconcile the different approaches, we noted that difficulties in applying the Standard arise when three conditions are present: (1) the enterprise has both specific and other (general) debt outstanding; (2) the interest rates associated with the general and specific debts differ; and (3) the amounts and/or timing of the specific borrowing are not coincident with the amounts or timing of the expenditures. These alternatives involve the application of a specific borrowing rate and a weighted average rate to the total of qualifying expenditures.

Given a problem in which these three conditions are present, the alternative solutions presented in accounting texts each appear consistent with some interpretation of the Standard. The balance of this article will demonstrate the internal inconsistencies within the Standard which allow each of these alternatives to be justified. We will accomplish this by the use of the illustration which follows.

A NUMERICAL ILLUSTRATION

Assume that a company begins construction of a qualifying asset on April 1 with an expenditure of $600,000. Two additional expenditures of $300,000 each were made on July 1 and October 1. The project was considered complete and ready for use on December 31.

The firm obtained a 15 percent construction loan for $600,000 on July 1 (the specific debt). During the year the firm also had outstanding additional debt of $1,200,000 at nine percent (the general debt).

Given these facts, the weighted average accumulated expenditures can be calculated as follows:

Calculation of Weighted Average Accumulated Expenditures

Date	Expenditures	×	Capitalization Period	=	Wtd. Average Accumulated Expenditures
4/1	$ 600,000		9/12		$450,000
7/1	300,000		6/12		150,000
10/1	300,000		3/12		75,000
Total	$1,200,000				$675,000

The amount of interest to be capitalized on the project is limited to the actual interest cost incurred by the firm during the accounting period [Para. 15]. It is necessary, then, to determine the actual interest cost incurred by this firm as shown below.

Calculation of Actual Interest

Construction note	$ 600,000	× 15% ×	6/12	=	$ 45,000
Five year note	1,200,000	× 9% ×	12/12	=	108,000
Actual Interest					$153,000

Given the facts, this firm will capitalize an amount less than or equal to its total interest cost of $153,000.

The calculations given above are generic in nature, that is, they are independent of the approach which will ultimately be used to compute the amount of interest to be capitalized. The difficulties with the Standard arise when one attempts to compute "avoidable interest."

CALCULATING AVOIDABLE INTEREST: A TECHNICAL PROBLEM

As mentioned previously, the computation of avoidable interest may involve the application of either (1) a specific borrowing rate, (2) a

[1]Examples of three approaches may be found in the following Intermediate Accounting Texts: Kieso and Weygandt, fourth edition (1983); Kieso and Weygandt, fifth edition (1986); Welsch, Newman, Zlatkovich, seventh edition (1986).

weighted average rate, to the total of qualifying expenditures, (3) or both. These alternatives, when applied to the illustration, produce significantly different results.

As we will show, the first alternative would be to capitalize an amount equal to $96,750 while the second would be to capitalize $74,250. Consequently, we are faced with an unfortunate situation where identical assets constructed under identical circumstances may carry different acquisition values.

This situation results from a conflict between the intent of the Standard as given in paragraph 12, and the computational guidance offered in paragraph 13. For convenience, these two paragraphs are reproduced in their entirety in the appendix to this paper.

Applying the Specific Borrowing Rate: The First Alternative

To apply the guidance in paragraph 13 to the illustration, the following computations could be made:[2]

Calculation of Avoidable Interest

Wtd. Average Accumulated Expenditures	×	Interest Rate	=	Avoidable Interest
$600,000		15%		$90,000
75,000		9%		6,750
$675,000				$96,750

This computation complies literally with paragraph 13. First, the specific borrowing rate of 15 percent is applied to the amount of accumulated expenditures which do not exceed the specific borrowing ($600,000). Then the rate on other debt (nine percent) is applied to the amount of accumulated expenditures which exceed the specific borrowing ($75,000).

However, the result fails to comply with the intent of the Standard. By applying the 15 percent specific borrowing rate to the average accumulated expenditures equal to the loan proceeds, this alternative capitalizes *more* interest than could have actually been avoided with respect to the specific debt. In fact, the amount calculated above is twice the interest cost actually incurred on this debt during the capitalization period. Certainly, this kind of result could not have been intended by the Board, since it so clearly fails to reflect the economic realities.

The overstatement of avoidable interest is a direct result of the Standard's definition of excess accumulated expenditures as the difference between the weighted average accumulated expenditures and the gross (unweighted) specific loan proceeds [Para. 13]. This definition results in a matching of weighted and unweighted amounts, which is difficult to justify theoretically.

The specific debt in this illustration could have provided *no more than* $300,000 of the average accumulated expenditures, since it is outstanding for only six months. In the calculation of avoidable interest, above, the loan proceeds are not weighted for the amount of time the funds are available. Thus the loan is treated as though it provided a full $600,000 of the average accumulated expenditures.

The overstatement of avoidable interest related to the specific debt occurs whenever the (1) capitalization period begins subsequent to the beginning of the period and (2) the average accumulated expenditures exceed the specific loan amount. In those cases, the results obtained from applying this alternative are identical to capitalizing interest *prior* to the beginning of the capitalization period.

Applying the Weighted Average Rate: The Second Alternative

The Standard states that an enterprise *may* use the specific borrowing rate as the capitalization rate. The Board's use of the word "may" rather than "shall" necessarily implies that an enterprise may choose *not* to consider the specific borrowing rate explicitly in its calculation of avoidable interest. In this case, the firm would calculate a weighted average of the rates associated with its outstanding debt. This would then be used as the capitalization rate to be applied to the total of average accumulated expenditures.

Given the facts in the illustration, the weighted average rate would be 11 percent. This rate would then be applied to the total average accumulated expenditures as follows:[3]

[2]An example of this method can be found in Kieso and Weygandt, *Intermediate Accounting*, fourth edition, pp. 482-484.

[3]An example of this approach can be found in Welsch, Newman, Zlatkovich, *Intermediate Accounting*, seventh edition, pp. 611-615.

Calculation of Avoidable Interest

Average Accumulated Expenditures	×	Interest Rate	=	Avoidable Interest
$675,000		11%		$74,250

Given the simplicity of the computation, its conformity with the Standard's computational guidance is clear. However, given a case where a specific borrowing exists, this alternative will neither fully adhere to the Standard's intent, nor reflect the economic realities.

The interest cost associated with the specific debt clearly could have been avoided if the construction project had not been undertaken. The weighted average approach, however, ignores the incremental nature of this debt. Instead, it views all borrowed funds as being commingled within a single pool from which expenditures are drawn.

Consequently, when a specific debt exists, this method disguises the fact that a portion of the firm's debt, and its interest cost, are directly associated with the project. This alternative offers an enterprise the opportunity to select a rate with which to capitalize interest on a basis unrelated to the facts. The representational faithfulness of the results, then, are questionable.

A Solution Based on Economic Facts

The Board's objective was that interest be capitalized "to obtain a measure of acquisition cost that more closely reflects the enterprise's total investment in the asset..." [Para. 7]. Incremental interest costs associated with the acquisition of an asset are considered to be a part of this total investment.

Difficulty in applying the Standard as a whole results from the fact that one cannot both adhere to the intent of the Standard, and comply with its computational guidelines, simultaneously. This is compounded by the fact that the computational guidelines provide for more than one "correct" method of application.

One approach to eliminating the conflict between the intent of the Standard and its computational guidelines would be to:

(1) Prescribe that the interest cost incurred on a specific borrowing during the capitalization period be included as part of the asset's cost. This could be accomplished quite simply by changing "may" to "shall" in sentence three of paragraph 13.

(2) Eliminate the matching of weighted and unweighted amounts by redefining excess accumulated expenditures as the difference between the weighted average accumulated expenditures and the *weighted average* loan amount.

Applying these changes to the illustration, we would calculate the following amounts:

Weighted average accumulated expenditures	$675,000
Weighted average loan amount ($600,000 × 6/12)	300,000
Excess average accumulated expenditures	$375,000
Interest to be capitalized:	
Specific borrowing (actual cost incurred)[a]	$ 45,000
Excess expenditures ($375,000 × 9%)	33,750
Avoidable Interest	$ 78,750

[a] During the capitalization period: $600,000 × 15% × 6/12

These changes would provide computational guidelines which, when applied to a single set of facts and circumstances, yield consistent results which adhere to the intent of the Standard, and are representationally faithful, as well.

When a debt is specifically associated with the acquisition of an asset, it is theoretically correct to capitalize all *interest cost* incurred on this debt during the capitalization period. The proposed solution would capitalize $45,000 —the actual amount of interest cost incurred, and therefore, clearly avoidable.

Additional funds expended beyond those obtained from the specific borrowing could theoretically have been used to repay other outstanding debt of the enterprise. The interest cost incurred as a result of *not* extinguishing this other debt is properly considered "avoidable," as well. In the proposed solution, the $33,750 represents interest on the excess expenditures of $375,000 which could have been used to eliminate a portion of the firm's nine percent debt.

In the case where an enterprise has no specific debt related to the project, all expenditures would be considered to be "excess

expenditures" to which a weighted average interest rate would be applied. This would be consistent with the view that all funds invested in the project could theoretically have been used to repay outstanding debt.

DEFINING AVOIDABLE INTEREST: A CONCEPTUAL PROBLEM

A solution to the technical problems discussed above could be accomplished by amending the Standard's computational guidelines. However, a conceptual problem still remains which cannot be solved simply by altering these guidelines.

This conceptual problem results from a lack of clarity with respect to the definition of avoidable interest. The interest capitalized is intended to be that which could have been avoided by "...avoiding additional borrowings OR by using the funds expended for the assets to repay existing borrowings" [Para. 12, emphasis added]. The Board's use of the word "or" leaves open the question as to whether the avoidance of additional borrowings or the use of funds invested in the asset for the theoretical repayment of existing debt is to receive preference.

Depending upon where one places emphasis, two solutions emerge. These can be demonstrated by altering the original illustration as follows. The date of the specific loan is changed to January 1, and an additional expenditure of $100,000 is also made on that date. The dates and amounts of subsequent expenditures remain unchanged. This results in weighted average accumulated expenditures of $775,000.

A solution which emphasizes the use of invested funds to repay existing debt is shown below.[4]

Invested Funds Used to Repay Existing Borrowings:			Weighted Avg. Accumulated Expenditures		Interest Rate		Avoidable Interest
$ 100,000	× 12/12	=	$100,000	×	15%	=	$15,000
500,000	× 9/12	=	375,000	×	15%	=	56,250
100,000	× 9/12	=	75,000	×	9%	=	6,750
300,000	× 6/12	=	150,000	×	9%	=	13,500
300,000	× 3/12	=	75,000	×	9%	=	6,750
$1,300,000			$775,000				$98,250

A second solution, which emphasizes the avoidance of additional borrowings is given below:

Weighted average accumulated expenditures	$775,000
Weighted average loan amount ($600,000 × 12/12)	600,000
Excess average accumulated expenditures	$175,000
Interest to be capitalized:	
Specific borrowing (actual cost incurred) [a]	$ 90,000
Excess expenditures ($175,000 × 9%)	15,750
Avoidable Interest	$105,750

[a] During the capitalization period.

This dilemma will arise whenever, at the date of the specific loan, the accumulated expenditures are less than the loan proceeds. It is the treatment of this difference which causes the results to differ.

The first solution assumes that avoidable interest accrues only on the funds invested in the asset. The second solution views the entire specific debt as avoidable and, therefore, the entire interest cost associated with it as avoidable.

The Standard, as currently written, provides insufficient guidance to determine which interpretation the Board intended. Again, the application of SFAS 34 to this set of circumstances may give results which are questionable in terms of their comparability and representational faithfulness.

SHOULD SFAS 34 BE REVISITED?

Users of accounting information properly expect that statements prepared in good faith will properly reflect the enterprise's activities and financial position. Unfortunately, the guidelines for implementation which were provided in the Standard are subject to alternative interpretations. Some of these interpretations may, as we have shown, produce results which conflict with the intent of the Standard. Consequently, the Standard is deficient in the sense that equally competent preparers dealing with identical circumstances may arrive at substantially different results.

Statements of Financial Accounting Standards should both limit diversity in practice, and, at least in part, insure the quality of the

[4] An example of this approach can be found in Kieso and Weygandt, *Intermediate Accounting*, fifth edition, pp. 417-418.

information presented. The Board, itself, noted in SFAC 2 that "Information about an enterprise gains greatly in usefulness if it can be compared with similar information about other enterprises..." [Para. 111]. SFAS 34 does not provide assurance with respect to the qualitative characteristics of verifiability and representational faithfulness.

As a result, this Standard may have done little to enhance comparability. There is a diversity of interpretation evident in the variety of presentations in accounting texts. This may be indicative of a diversity in practice, as well.

Due to the inability of this Standard to insure the qualitative aspects of the financial information being reported, and the potential for diversity of application in practice, we believe that an examination of SFAS 34 by the Board is warranted.

APPENDIX

Paragraph 12: The intent of the Standard.

"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."

Paragraph 13: The computational guidelines.

"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."