

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Rel. No. 5505/June 21, 1974

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 10872/June 21, 1974

CAPITALIZATION OF INTEREST BY COMPANIES OTHER THAN PUBLIC UTILITIES (S7-527)

The Commission has noted with concern an increase in the number of non-utility companies changing their accounting method to a policy of capitalizing interest cost. The Commission proposes to issue the following accounting series release discussing the problem and adopting an accounting policy and amendments to Regulation S-X.

A. Commentary

The conventional accounting model applicable to companies other than public utilities has not traditionally treated the cost of capital as part of the cost of an asset, although no authoritative statement on this subject presently exists. Interest cost on debt is generally treated as a period expense of the period during which debt capital is used, while the cost of equity capital is reflected neither in asset cost nor in the income statement.

This approach has been adopted for a number of reasons. First, it is impossible to follow cash once it has been invested in a firm. Even when a loan is made for a designated purpose and secured by a lien on specific assets, it can be argued that capital made available for one purpose frees other capital for other purposes, and it is therefore unrealistic to allocate the cost of any particular financing to any particular asset. Thus any allocation of capital cost to particular assets is based on allocation decisions which are inherently arbitrary.

Second, the cost of capital is extremely difficult to measure. While interest rates may be associated with borrowings, any debt normally rests in part on the existence of an equity base which provides borrowing capacity. Suppliers of debt capital almost inevitably look to a borrower's overall economic position in making credit granting decisions. In addition, restrictive covenants and other terms such as compensating balance requirements may make the stated interest rate an unrealistic measure of capital. The cost of common equity capital is even more difficult to measure since it represents the cost of sharing an uncertain future earnings stream rather than a contractual out of pocket payment.

Third, it has been felt that interest costs were generally costs of a continuing nature, usually fixed by contract, and that deferral of certain of these costs might leave an erroneous impression as to the level of interest expense (and the cash outlay for interest) that might be expected in the future. Interest would not halt, for example, when an asset constructed with the use of capital funds was completed and placed in service.

For these reasons, interest cost has generally been reflected as an expense of the period during which capital was used rather than associated with the assets acquired by the use of the capital, even though it can be argued that interest cost is a cost which should be allocated to assets like other costs and that expensing interest as accrued is not consistent with the matching model in general use.

The Commission has recently noted, however, an increasing number of cases where interest has been capitalized by registrants other than electric, gas and water utilities. This has created a source of incomparability between financial statements of companies following different practices in this respect.

While the Commission recognizes that arguments can be made for each of the accounting practices in this area, 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 and water utilities which had not, as of June 21, 1974, publicly disclosed an accounting policy of capitalizing interest costs shall not adopt such a policy. 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 do have such a policy may continue to apply it on a consistent basis, but not extend it to new types of assets. Such companies shall make full disclosure of the amount capitalized both cumulatively on the balance sheet and in any year for which an income statement is presented; in addition, the effect on net income of this accounting policy as compared to a policy of expensing interest as accrued shall be disclosed. Capital costs other than interest (such as a return on equity invested) shall not be capitalized by companies other than electric, gas and water utilities.

Since capitalization of capital costs of funds used in construction by electric, gas and water utilities is based on rate making considerations, no change in accounting for such costs is proposed herein.

B. PROPOSED AMENDMENTS TO REGULATION S-X

The following addition to Rule 3-16 of Regulation S-X is proposed:

Rule 3-16(t) Interest capitalized

Companies other than electric, gas and water utilities which prior to June 21, 1974 had adopted a policy of capitalizing interest cost shall make the following disclosures:

- (1) The amount of interest cost capitalized in each period for which an income statement is presented shall be shown within the income statement;
- (2) The reason for the policy of interest capitalization and the way in which the amount to be capitalized is determined;
- (3) The effect on net income for each period for which an income statement is presented of following a policy of capitalizing interest as compared to a policy of charging interest to expense as incurred; and
- (4) The amount of interest capitalized in any balance sheets presented, including the asset categories in which interest is included and the amount of interest in each.

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The above proposals would be adopted pursuant to authority conferred on the Commission by the Securities Act of 1933, particularly Sections 6, 7, 8, 10 and 19(a) thereof; and The Securities Exchange Act of 1934, particularly Sections 12, 13, 15(d) and 23(a) thereof.

It is anticipated that the proposed amendments, if adopted, will be made applicable to all financial statements filed on or after December 31, 1974.

With respect to registration statements and reports filed subsequent to the publication of these proposals, where financial statements reflect capitalization of interest the staff will through the comment process request registrants to report the total interest capitalized for each period as a separate line item in the statements of income and operations. In the past, interest capitalized has customarily been disclosed in notes to financial statements except for electric, gas and water utilities that have disclosed interest capitalized as a separate line item in statements of income and operations. However, a registrant that adopts an interest

capitalization policy that would have to be changed if this proposal is adopted will be required to disclose the proposal and the effect that retroactive application to June 21, 1974, will have on reported net income.

All interested persons are invited to submit their views and comments with respect to the foregoing release and proposals on or before August 31, 1974. All such views and comments should be submitted to the Secretary, Securities and Exchange Commission, Washington, D.C. 20549. Such communications should refer to File No. S7-527. All such communications will be available for public inspection.

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By the Commission

George A. Fitzsimmons
Secretary