GASB Exposure Draft

November 20, 2017

Comments Due: March 5, 2018

Proposed Statement

of the Governmental Accounting Standards Board

Accounting for Interest Cost during the Period of Construction

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities
Project No. 9-5

Governmental Accounting Standards Board

ACCOUNTING FOR INTEREST COST DURING THE PERIOD OF CONSTRUCTION

WRITTEN COMMENTS

Deadline for submitting written comments: March 5, 2018

Requirements for written comments. Comments should be addressed to the Director of Research and Technical Activities, Project No. 9-5, and emailed to director@gasb.org.

OTHER INFORMATION

Public hearing. The Board has not scheduled a public hearing on the issues addressed in this Exposure Draft.

Public files. Written comments will become part of the Board's public file and are posted on the GASB's website.

This Exposure Draft may be downloaded from the GASB's website at www.gasb.org.

Final GASB publications may be ordered at www.gasb.org.

Notice to Recipients of This Exposure Draft

The Governmental Accounting Standards Board (GASB) is responsible for (1) establishing and improving standards of state and local governmental accounting and financial reporting to provide useful information to users of financial reports and (2) educating stakeholders—including issuers, auditors, and users of those financial reports—on how to most effectively understand and implement those standards.

The due process procedures that we follow before issuing our standards and other communications are designed to encourage broad public participation in the standards-setting process. As part of that due process, we are issuing this Exposure Draft setting forth a proposed Statement that would require interest cost incurred during a construction period to be recognized as an outflow of resources of that period, subject to the measurement focus.

We invite your comments on all matters in this proposed Statement. Because this proposed Statement may be modified before it is issued as a final Statement, it is important that you comment on any aspects with which you agree as well as any with which you disagree. To facilitate our analysis of comment letters, it would be helpful if you explain the reasons for your views, including alternatives that you believe the GASB should consider.

All responses are distributed to the Board and to staff members assigned to this project, and all comments are considered during the Board's deliberations leading to a final Statement. In deciding on changes in accounting and financial reporting standards, the GASB also takes into consideration the expected benefits to users of financial statements and the perceived costs of preparing and reporting the information. When the Board is satisfied that all alternatives have adequately been considered, and modifications have been made as considered appropriate, a vote is taken on the Statement. A majority vote is required for adoption.

Summary

The objectives of this proposed Statement are (1) to enhance the relevance and comparability of information about capital assets and the cost of borrowing for a reporting period and (2) to simplify accounting for interest cost incurred during the period of construction.

This proposed Statement would require that interest cost incurred during the period of construction be recognized as an expense in the period in which the cost is incurred for financial statements prepared using the economic resources measurement focus. As a result, interest cost incurred during a period of construction would no longer be included in the historical cost of a capital asset reported in a business-type activity or enterprise fund.

This proposed Statement also would reiterate that in financial statements prepared using the current financial resources measurement focus, interest cost incurred during the period of construction should be recognized as an expenditure on a basis consistent with governmental fund accounting principles.

Effective Date and Transition

The requirements of this proposed Statement would be effective for reporting periods beginning after December 15, 2018. Earlier application would be encouraged. The requirements of this proposed Statement would be applied prospectively.

How the Changes in This Proposed Statement Would Improve Financial Reporting

The requirements of this proposed Statement would improve financial reporting by providing users of financial statements with more relevant information about capital assets and the cost of borrowing for a reporting period. The resulting information also would enhance the comparability of information about capital assets and the cost of borrowing for a reporting period of both governmental activities and business-type activities.

How the Board Considered Costs and Benefits in the Development of This Proposed Statement

One of the principles guiding the Board's setting of standards for accounting and financial reporting is the assessment of expected benefits and perceived costs. The Board strives to determine that its standards address significant user needs and that the costs incurred through the application of its standards, compared with possible alternatives, are justified when compared to the expected overall public benefit. The Board believes that the expected benefits that would result from the information provided through implementation of this proposed Statement—more relevant and comparable information about capital assets and the cost of borrowing for a reporting period and reduced complexity of the accounting requirements—outweigh potential initial and ongoing costs. In addition, the Board believes that the costs of applying the proposed requirements generally would be less than the costs of applying current requirements for capitalization of interest cost. To further reduce the cost of implementation of the proposed provisions, this proposed Statement would require that the provisions be applied prospectively.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraph 2 discusses the applicability of this Statement.

Proposed Statement of the Governmental Accounting Standards Board

Accounting for Interest Cost during the Period of Construction

November 20, 2017

CONTENTS

Paragraph Numbers

Proposed Statement of the Governmental Accounting Standards Board

Accounting for Interest Cost during the Period of Construction

November 20, 2017

INTRODUCTION

1. The objectives of this Statement are (a) to enhance the relevance and comparability of information about capital assets and the cost of borrowing for a reporting period and (b) to simplify accounting for interest cost incurred during the period of construction.

STANDARDS OF GOVERNMENTAL ACCOUNTING AND FINANCIAL REPORTING

Scope and Applicability of This Statement

2. The requirements of this Statement apply to the financial statements of all state and local governments.

3. This Statement supersedes Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus,* paragraph 6; Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements,* paragraphs 5–22 and footnotes 1–7; and *Implementation Guide No. 2015-1,* Questions 7.10.3–7.10.7. This Statement amends Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* paragraph 18, and Statement 62, paragraphs 3 and 485.

Accounting for Interest Cost during the Period of Construction

4. In financial statements prepared using the economic resources measurement focus, interest cost incurred during the period of construction should be recognized as an expense in the period in which the cost is incurred. Such interest cost should not be capitalized as part of the historical cost of a capital asset.

5. In financial statements prepared using the current financial resources measurement focus, interest cost incurred during the period of construction should be recognized as an expenditure on a basis consistent with governmental fund accounting principles.

EFFECTIVE DATE AND TRANSITION

6. The requirements of this Statement are effective for reporting periods beginning after December 15, 2018. Earlier application is encouraged. Changes adopted to conform to the

provisions of this Statement should be applied prospectively. For construction-in-progress, interest cost incurred after the beginning of the first reporting period to which this Statement is applied should not be capitalized.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

BACKGROUND

A1. Prior to the issuance of this Statement, governments capitalized interest cost incurred during the period of construction in business-type activities and enterprise funds. Those requirements, as incorporated into GASB Statement 62, were based on Financial Accounting Standards Board (FASB) Statements No. 34, *Capitalization of Interest Cost,* and No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants,* which were issued in 1979 and 1982, respectively. The approach taken with respect to incorporating FASB literature into GASB Statement 62 was to adopt accounting and reporting requirements essentially as they existed in the applicable pre-November 30, 1989 FASB and American Institute of Certified Public Accountants pronouncements. The language of those pronouncements was modified as appropriate to recognize the effects of the governmental environment without affecting the substance of the provisions. As a result, at that time, the Board did not consider consistency of the provisions with GASB Concepts Statements.

A2. In December 2016, the Board added a project to reexamine the requirements for capitalization of interest cost to the practice-issue portion of the GASB's current technical agenda. Deliberations began in July 2017. Feedback on the project was provided by Governmental Accounting Standards Advisory Council members at their December 2016 and October 2017 meetings.

Appendix B

BASIS FOR CONCLUSIONS

Introduction

B1. This appendix discusses factors considered significant by Board members in reaching the conclusions in this Statement. It includes discussion of the alternatives considered and the Board's reasons for accepting some and rejecting others. Individual Board members may have given greater weight to some factors than to others.

Scope and Applicability of This Statement

B2. As discussed in Appendix A, the Board reconsidered the requirements in Statement 62 regarding capitalization of interest cost incurred during the period of construction in business-type activities and enterprise funds. In addition, the Board reconsidered the accounting for interest cost incurred during the period of construction for government-wide statements (governmental and business-type activities) and fund statements (governmental, proprietary, and fiduciary funds). As a result, this Statement includes requirements that address both financial statements prepared using the economic resources measurement focus and those prepared using the current financial resources measurement focus.

Classification of Interest Cost

B3. In this project, the Board followed the hierarchy that was utilized when developing Statement No. 65, *Items Previously Reported as Assets and Liabilities,* and first considered whether interest cost incurred during the period of construction is an asset as defined in Concepts Statement No. 4, *Elements of Financial Statements.* Paragraph 8 of Concepts Statement 4 defines assets as "resources with present service capacity that the government presently controls." Present service capacity is described as an "existing capability to enable the government to provide services, which in turn enables the government to fulfill its mission" (paragraph 9).

B4. The Board agreed that, if considered separately from a capital asset, costs incurred for interest would not meet the definition of an asset because the costs themselves are not a resource with present service capacity. Therefore, in determining whether interest cost incurred during the period of construction meets the definition of an asset, the Board considered whether that interest cost is an acquisition cost that is inseparable from the capital asset and thus enhances the service capacity of that asset. The Board concluded that interest cost incurred during the construction period is a financing activity separate from the capital asset that does not enhance the present service capacity of an asset because, regardless of whether interest cost is incurred during the period of construction, the asset will have the same ability to provide services.

B5. The Board also considered differences between interest cost incurred during the period of construction and ancillary charges, which continue to be capitalized as part of the historical cost of a capital asset in accordance with paragraph 18 of Statement 34. Ancillary charges (for example, freight and transportation charges, site preparation costs, and certain professional fees) are directly attributable to the asset acquisition; without those costs, the asset could not be placed into service. The Board believes that activities that generate ancillary charges enable the government to use the asset to provide services; therefore, those amounts are included in the asset's historical cost. That is, those activities enhance the service capacity of the capital asset.

B6. In addition to present service capacity, the Board believes that ancillary charges are different from interest cost incurred during the period of construction because, although linked in some cases, a decision to acquire or construct a capital asset still is separate from a decision about how to finance that asset. That is, after a decision has been made to acquire or construct a capital asset, ancillary charges would be incurred regardless of how the acquisition or construction is financed. Therefore, the Board concluded that interest cost incurred during the period of construction is different from ancillary charges in that interest cost is associated with the financing of a capital asset rather than with the preparation of the asset for use and the asset's ability to provide services.

B7. After concluding that interest cost incurred during the period of construction does not meet the definition of an asset, the Board next considered whether that interest cost meets the definition of a deferred outflow of resources. A deferred outflow of resources is defined in paragraph 32 of Concepts Statement 4 as "a consumption of net assets by the government that is applicable to a future reporting period." The Board concluded that interest cost incurred during the period of construction does not meet the definition of a deferred outflow of resources because it is a periodic cost applicable to the *current* reporting period. Incurring interest during the period of construction does not, in the view of the Board, change the reporting period to which the cost relates. Therefore, based on the hierarchy, the Board concluded that interest cost incurred during the period of construction meets the definition of an outflow of resources in paragraph 24 of Concepts Statement 4—"a consumption of net assets by the government that is applicable to the reporting period" (footnote reference omitted).

Other Considerations

B8. In addition to the definitions established in Concepts Statement 4, the Board considered certain other factors in determining whether interest cost incurred during the period of construction should be capitalized, including the comparability of capital asset information in government-wide financial statements, complexity, and the accounting treatment of interest cost by other standards setters.

B9. Regarding comparability of capital asset information in government-wide financial statements, accounting requirements for interest incurred during a period of construction were different for business-type activities and governmental activities prior to the issuance of this Statement. Consequently, if a government constructed two identical assets—one associated with governmental activities and the other with business-type activities—those assets could have different historical costs because interest cost would be capitalized only for the capital asset used in business-type activities. The Board believes it is misleading to assign different values to the same assets constructed under similar circumstances and notes that the definition of an asset in Concepts Statement 4 applies equally to governmental and business-type activities.

B10. Additionally, the Board believes that this Statement eliminates the complex accounting for interest cost incurred during the period of construction. Prior to the issuance of this Statement, the amount of interest capitalized during the construction period generally was calculated by determining an appropriate capitalization rate and applying that rate to the "average of accumulated outlays" for the assets constructed or acquired during the period. Additional complexity related to identifying qualifying assets, measuring the amount to be capitalized, and determining the capitalization period arose in situations in which the construction or acquisition was financed with tax-exempt borrowings. Therefore, the Board believes eliminating the requirement to capitalize interest in business-type activities and enterprise funds reduces the complexity of accounting requirements for capital assets.

B11. The Board recognizes that the requirements regarding the treatment of interest cost in this Statement are a change from current practice and create differences with some other standards setters' guidance. However, as discussed above, the Board believes the classification of interest cost as an outflow of resources, rather than an asset, is more consistent with the definitions of elements of financial statements as established by Concepts Statement 4.

B12. The Board also considered the effects of this Statement on business-type activities that have regulated operations that meet the criteria set forth in paragraph 476 of Statement 62 regarding regulated operations and elect to apply the provisions of paragraphs 476–500 of Statement 62. The Board concluded that, provided the criteria for regulated operations are met and the entity has elected to apply the related provisions of Statement 62, the requirements in paragraph 485 of that Statement regarding capitalization of qualifying interest cost as a regulatory asset should remain applicable.

Considerations Related to Benefits and Costs

B13. The overall objective of financial reporting by state and local governments is to provide information to assist users (the citizenry, legislative and oversight bodies, and investors and creditors) in assessing the accountability of governments and in making economic, social, and political decisions. One of the principles guiding the Board's setting of standards for financial reporting is the assessment of the expected benefits and perceived costs. The Board strives to determine that its standards address a significant user need and that the costs incurred through the application of its standards, compared with possible alternatives, are justified when compared to the expected overall public benefit.

B14. Present and potential users are the primary beneficiaries of improvements in financial reporting. Persons within governments who are responsible for keeping accounting records and preparing financial statements, as well as managers of public services, also benefit from the information that is collected and reported in accordance with GASB standards. The costs to implement the standards are borne primarily by governments and, by extension, their citizens and taxpayers. Users also incur costs associated with the time and effort required to obtain and analyze new information to meaningfully inform their assessments and decisions.

B15. The Board's assessment of the expected benefits and perceived costs of issuing new standards is unavoidably more qualitative than quantitative because no reliable and objective method has been identified for quantifying the value of improved information in financial statements. Furthermore, it is difficult to accurately measure the costs of implementing new standards until implementation has taken place. Nonetheless, the Board undertakes this assessment based on the available evidence regarding expected benefits and perceived costs with the objective of achieving an appropriate balance between maximizing benefits and minimizing costs.

B16. Regarding expected benefits of this Statement, the Board believes that the requirements will benefit users by providing enhanced relevance and comparability of information about capital assets and the cost of borrowing for a reporting period. The Board believes that preparers and auditors will benefit from the removal of the requirement to capitalize interest because this change will reduce complexity in accounting for capital assets.

B17. Although the Board recognizes that it is difficult to accurately measure the costs of implementing new standards, the Board does not anticipate that implementation or ongoing application of the requirements will result in significant costs or effort. The Board believes that the prospective transition approach mitigates implementation costs. Furthermore, the Board believes that over time, the costs of applying this Statement generally will be less than the costs of applying the capitalization requirements of Statement 62 because the requirements of this Statement are less complex.

B18. Considering the benefits of providing more relevant and comparable information about capital assets and the cost of borrowing for a reporting period and the anticipated minimal implementation and ongoing costs, the Board believes that the expected benefits of this Statement justify the perceived costs.

Effective Date and Transition

B19. The provisions of this Statement are effective for reporting periods beginning after December 15, 2018. The Board concluded the effective date provides sufficient time for implementation and transition because the Board believes minimal effort will be required to apply the requirements. In addition, in the Board's view, minimizing the period during which interest cost continues to be capitalized for in-progress capital assets (that is, the period between issuance of this Statement and the effective date of this Statement) supports providing more relevant and comparable measures of capital assets and the cost of borrowing. Some governments may wish to implement the guidance earlier than the effective date, which this Statement encourages.

B20. With respect to transition, the Board concluded that it is appropriate to require prospective application of the provisions of this Statement. In developing transition provisions, the Board also considered a retroactive approach and a modified prospective approach. The Board concluded that a prospective approach would be less costly than a retroactive approach because a prospective approach does not require restatement of any balances (including capital assets that are in service, construction-in-progress, and accumulated depreciation) or adjustments to beginning balances to remove interest that previously has been capitalized. For the modified prospective approach, the requirements would have been applicable only to projects initiated after the beginning of the reporting period to which this Statement is first applied (that is, for construction-in-progress, governments would have continued to apply the requirements of Statement 62 and to capitalize interest until those assets were placed into service). However, the Board concluded that, unlike the prospective approach (which results in comparable borrowing cost information in the first period to which this Statement is applied), a modified prospective approach that would require interest cost to continue to be capitalized would be counter to the objectives of (a) enhancing the relevance and comparability of borrowing cost information and (b) simplifying accounting requirements. Although the transition requirements in this Statement result in capitalization of interest cost for construction-in-progress only to the implementation date, the Board believes that the only transition approach that would enhance comparability of capital assets at the implementation date is a retroactive approach that removes, for all capital assets (both those in service and in progress), the effects of interest previously capitalized. As discussed above, the Board concluded that the costs of a retroactive approach outweigh the benefits of the information that would be provided.

Appendix C

CODIFICATION INSTRUCTIONS

Codification of Governmental Accounting and Financial Reporting Standards—December 2018 Update

C1. The instructions that follow update the June 30, 2017 *Codification of Governmental Accounting and Financial Reporting Standards* (Codification) for the effects of this Statement. Only the paragraph number of the Statement is listed if the paragraph will be cited in full in the Codification.

* * *

[Update cross-references throughout.]

* * *

SUMMARY STATEMENT OF PRINCIPLES SECTION 1100

Sources: [Remove GASB Statement 37.]

[Add GASBS XX, ¶4 as an amending source of GASBS 34, ¶18; remove GASBS 37, ¶6 from sources.]

* * *

REPORTING CAPITAL ASSETS SECTION 1400

Sources: [Remove GASB Statement 37; add GASB Statement XX.]

[In Statement of Principle, Valuation of Capital Assets, add GASBS XX, ¶4 as an amending source of GASBS 34, ¶18; remove GASBS 37, ¶6 from sources.]

.102 [Insert the following after the third sentence:] Interest cost incurred during the construction period of a capital asset should not be capitalized as part of the asset's historical cost. [GASBS 34, ¶18, as amended by GASBS 72, ¶79 and GASBS XX, ¶4; GASBS 72, ¶68; GASBS XX, ¶4]

[Replace paragraphs .120–.137, including headings and footnotes, with the following; renumber subsequent paragraphs and footnotes.]

Interest Cost during the Period of Construction

.120 [GASBS XX, ¶4]

.121 [GASBS XX, ¶5]

[Delete Questions .702-8 and .702-9; renumber subsequent questions.]

[Replace headings .711–.717 and associated text with the following; renumber subsequent headings and associated questions.]

.711 Interest Cost during the Period of Construction

No questions assigned.

* * *

COMPREHENSIVE ANNUAL FINANCIAL REPORT SECTION 2200

[Delete Question .715-1; renumber subsequent questions.]

* * *

INTEREST COSTS—IMPUTATION SECTION I30

See also: [Delete the reference to Section 1400.]

* * *

REGULATED OPERATIONS SECTION Re10

.110 [Replace the fourth sentence, including footnote 6, with the following; renumber subsequent footnotes.] In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets should be capitalized as a regulatory asset for financial reporting purposes. [GASBS 62, ¶485, as amended by GASBS 63, ¶8 and GASBS XX, ¶4]

* * *

Codification—December 2019 Update

C2. The instructions that follow update paragraph C1 of Statement No. 87, *Leases*, for the effects of this Statement. Statement 87 is effective for reporting periods beginning after December 15, 2019.

* * *

[Do not apply the instructions for paragraphs .120 and .121.]

* * *

Comprehensive Implementation Guide—December 2018 Update

C3. The instructions that follow update the June 30, 2017 *Comprehensive Implementation Guide* for the effects of this Statement.

* * *

[Delete Questions 7.10.3–7.10.7.]