GASB Updates Interest Capitalization Rules

Early this year, the Governmental Accounting Standards Board (GASB) released Statement No. 89, *Accounting for Interest Cost Incurred before the End of a Construction Period*. Currently, interest capitalization requirements differ between business-type activities (BTA) and governmental activities. Under the new guidance, all governmental entities would recognize interest costs incurred before the end of a construction period as an expense or expenditure of the period. These costs would not be included in the historical cost of a capital asset, as was previously required for enterprise funds. GASB believes the changes will enhance comparability of information between governmental entities about capital assets and a reporting period's borrowing costs.

This short statement is a substantial change from current practice for enterprise funds. Previously, entities had to determine an appropriate capitalization rate and apply that rate to the average of accumulated outlays for the assets constructed or acquired during the period. Some entities also were challenged in the identification of qualifying assets, measuring the amount to be capitalized and determining the capitalization period in situations in which the construction or acquisition was financed with tax-exempt borrowings. Nonregulated governmental entities with infrequent capital projects or a manual calculation process likely will welcome this change and may want to consider early adoption.

However, entities with large, ongoing capital projects and highly automated calculation systems may face significant operational challenges in adopting the new rule. This statement upends current practice and the amounts can be substantial, *e.g.*, Orlando International Airport's $2.2 billion terminal expansion includes $165 million of capitalized interest and the Dallas Fort Worth International Airport terminal renovations resulted in $100 million in capitalized interest. The biggest impacts will be to municipal utilities, public sector airport and transit agencies and tribal casinos. These entities have built complicated models to comply with regulated rate-setting requirements. Under the new rules there will be differences between the regulatory rate-setting process and the financial reporting requirements for capitalized interest. Regulated municipal utilities and airport agencies may need to update their rate-setting processes to reflect the changes to capitalized interest, as capitalized interest will become a regulatory asset instead of a component of a capital asset.

The statement also is a departure from public company accounting standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Both FASB and IASB require the capitalization of interest, and GASB's new accounting treatment will result in differences in how governmental entities report these costs as compared to privately run entities, *i.e.*, public sector versus private hospitals and utilities. Entities that are regularly compared to publicly traded enterprises will see unfavorable changes to common financial ratios, *i.e.*, debt to equity and capital expenditures to depreciation. This lack of comparability between public and private sector financial statements may have an effect on future borrowing capacity and current debt covenants.

Effective Date

Statement No. 89

Reporting periods beginning after December 15, 2019

Background

BTAs or enterprise funds are currently **required** to capitalize interest cost incurred during the period of construction. Capitalizing these interest costs for governmental activities is not allowed. This discrepancy stems from GASB's history, whereby governments followed certain FASB pronouncements for their BTAs and enterprise funds.

When these legacy FASB pronouncements were directly incorporated into GASB literature in Statement 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, they retained their applicability only to those certain financial statements, highlighted in the table below.

Governmental Fund Type Comparison		
	Governmental Funds	**Enterprise Funds/BTAs**
Description	Services largely funded through nonexchange revenues (taxes)	Services primarily funded through user charges
Measurement Focus *(what transactions are recorded)*	Flow of current financial resources. This focus measures financial resources available to the entity in the near future as a result of transactions and events of the fiscal period reported. Long-term assets and liabilities are not reflected on a governmental fund's balance sheet	Flow of economic resources. This measurement focus generally is the same as that used by commercial entities. Both long-term assets and liabilities are reported on an enterprise fund's balance sheet
Basis of Accounting *(when transactions are recorded)*	Modified accrual basis	Accrual basis
Cash Flow Statement	No	Yes

Basis for Conclusion

Statement 89 reflects GASB's conclusion that interest costs do not meet the definition of an asset. GASB concluded the financing activity does not enhance an asset's present service capacity because the asset will have the same ability to provide services, regardless of whether interest is incurred. GASB also concluded interest costs are not deferred outflow of resources, defined as "a consumption of net assets by the government that is applicable to a future reporting period," because they are periodic costs related to the current reporting period. Unlike FASB, GASB's conceptual framework does not include a matching principal to defer expenses until the related revenue is recognized.

Ancillary Charges

The statement does not change the capitalization of ancillary charges incurred in the acquisition of capital assets. Ancillary charges included freight and transportation charges, site preparation costs and certain professional fees that are directly attributable to the asset's acquisition. GASB concluded ancillary charges enable the government to use the asset to provide service and, therefore, the amounts should be included in an asset's historical cost. GASB noted that ancillary charges would be incurred regardless of how the acquisition or construction is financed.

Transition & Effective Date

The new guidance is effective for periods beginning after December 15, 2019. The changes would be applied on a prospective basis—governments would discontinue capitalizing interest at implementation but would not be required to revalue assets for interest previously capitalized. 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. Early adoption is permitted.

Regulated Operations

Statement 89 does not change the applicability of capitalization of qualifying interest cost as a regulatory asset for BTAs that have regulated operations, as set forth in Statement 62. Statement 62 recognizes the rate-making process may give rise to an asset for which future revenues likely are to be sufficient to recover costs. Under this specialized accounting guidance, the regulatory asset is amortized over the period in which the related cost is recovered in rates. This accounting treatment is relatively consistent with current practice for capitalizing interest, but has specific criteria for eligibility.

Business activities that meet the below criteria may apply the provision in reporting qualifying interest as a regulatory asset:

- The regulated BTA's rates for regulated customer services are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers
- The regulated rates are designed to recover the specific regulated BTA's costs of providing the regulated services
- In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume rates set at levels that will recover the regulated BTA's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs

A regulated BTA should capitalize all or part of an incurred cost that otherwise would be charged to expense if both of the following criteria are met:

- It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes
- Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost

Allowance for Resources Used During Construction

In some cases, a regulator requires a regulated BTA to capitalize the cost of financing construction as part of the cost of capital assets if the project is financed partially by borrowings and partially by fund equity. The sum of a computed interest cost and a designated cost of equity funds is capitalized, and the change in net assets for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets should be capitalized for financial reporting purposes. Those amounts should be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable. The flows statement should include an item of other revenue, a reduction of interest expense or both in a manner that indicates the basis for the amount capitalized.

BKD will continue to monitor this and other GASB projects. For more information, contact your BKD advisor.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com