Capitalization of Interest

I. Purpose

To provide a framework and guidance for including the allowable amount of interest cost, with the other costs associated with bringing an asset to the condition for its intended use, for capitalization.

II. Responsibilities

A. Department
   1. Maintain/update project attributes, which are used to determine whether an asset qualifies for capitalized interest.
   2. If capitalized interest is split between complete and incomplete portions of a project, provide data as necessary for allocation method determined by Accounting and Financial Reporting Services.

B. Accounting and Financial Reporting Services
   1. Perform necessary computations to determine amount of interest to capitalize.
   2. If capitalized interest is split between complete and incomplete portions of a project, determine an appropriate allocation method.
   3. Create the journal voucher to capitalize the interest.

III. Policy

A. 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. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of outlays for the asset is a part of the historical cost of acquiring the asset.

B. The amount of interest cost to be capitalized for qualifying assets is intended to be the portion of the interest cost incurred during the assets' acquisition periods that theoretically could have been avoided if outlays for the assets had not been made (for example, by avoiding additional borrowings or by using the resources expended for the assets to repay existing borrowings).

IV. Procedures

A. To determine whether interest expense from a borrowing will be capitalized, the following steps are performed:
   1. Determine Which Assets Qualify for Capitalization of Interest. Qualifying assets include assets under construction for the university's own use, such as buildings/renovations over $100,000 and machinery separately budgeted and tracked.
   2. Determine the Capitalization Period. The capitalization period begins when all three of the following conditions have been met:
      a. Expenditures for the asset have been made (i.e., the university has made cash payments or has incurred debt for construction of the asset).
      b. Necessary activities to get the asset ready for its intended use are in progress (i.e., actual construction work is taking place).
      c. Interest cost is being incurred (i.e., the university has some type of interest-bearing debt outstanding). This debt need not be specific debt incurred on the asset (i.e., debt issued by the university to fund a

specific capital construction project). It may be general debt such as bonds payable. Therefore the university may capitalize interest cost even though the entire construction cost of the asset was paid for in cash, so long as the university has some type of interest-bearing debt outstanding.

3. Compute the Expenditures Made During the Capitalization Period. An expenditure may be financed either with cash payments or with the incurrence of debt. Whenever an expenditure (University funds only, not from grants, gifts, etc.) is made on a qualifying asset, the qualifying asset account is debited and either the cash account or a liability account is credited.
4. Compute Weighted-Average Accumulated Expenditures. The amount of expenditures on qualifying assets usually varies considerably; it builds up or accumulates as additional expenditures are made during the year. In order to determine the interest cost associated with these expenditures, it is necessary first to compute the weighted-average accumulated expenditures. This figure is an "average" or "annualized" quantity representing the average amount of funds tied up in construction throughout the year.
5. Compute Avoidable Interest. This computation is to estimate the amount of interest that theoretically could have been avoided if expenditures had not been made on qualifying assets. Four procedures are followed before avoidable interest is computed:
   a. Identify the university's outstanding debt and classify either as:
      1) Specific debt—debt incurred specifically to finance the construction of an asset.
      2) General debt—all university debt excluding specific debt.
   b. Further classify debt (and qualifying assets) by business area.
   c. Determine the appropriate interest rates to apply to the weighted average accumulated expenditures.
      1) Specific debt rate—the interest rate associated with specific debt.
      2) General debt rate—a weighted-average of interest rates incurred on all other outstanding debt during the period.
   d. Compute the avoidable interest.
      1) Multiply the specific debt interest rate times the portion of the weighted-average accumulated expenditures that is less than or equal to the amount of specifically borrowed debt.
      2) Multiply the weighted-average of interest rates incurred on all other general debt times the portion of the weighted-average accumulated expenditures that is greater than the specific debt.
6. Compute the Actual Interest Cost Incurred. It would not be reasonable to capitalize more interest than the total amount of interest cost actually incurred.
7. Determine the Interest Cost to be Capitalized. The interest cost to be capitalized is the avoidable interest or the actual interest, whichever is less. The amount of interest capitalized is debited to an asset account along with the construction and other costs of acquiring the asset. These costs are depreciated over the asset's expected useful life. The amount of interest cost expensed is written off immediately to interest expense.