1 INTRODUCTION

1.1 The development of the practice of capitalisation

The accounting treatment of the costs incurred on borrowings obtained to finance asset acquisitions achieved prominence in the UK through the growth of the large property companies in the 1950s and 1960s. However, as a result of the House of Lords decision in the Chancery Lane case\(^1\) in 1966, the accounting treatment of property company development interest was frequently governed by the achievement of a particular tax result, rather than being based on sound accounting principles.

In Chancery Lane, the company had borrowed money on mortgage to finance the rebuilding of its premises and the erection of new buildings. On the advice of its auditors, and in order to increase the amount available for dividends, the company capitalised a proportion of the interest in its financial statements. It was held, however, that since the company’s decision to attribute part of the interest to capital had a practical effect on the distributable fund represented by the balance on the profit and loss account, the company could not make an inconsistent attribution for tax purposes. Thus the principle was established whereby interest paid by a company and charged directly to capital was not tax deductible.

As a result, property groups used one of two methods to achieve the effect of capitalisation without losing tax relief. The first of these involved writing off the borrowing costs in the financial statements of individual companies within a group, and capitalising only in the consolidated financial statements. The second method was to charge the interest in the profit and loss account, but subsequently to remove it as a reserves transfer. The latter method, however, was regarded as questionable, especially following the decision of the House of Lords in the Fitzleet case\(^2\) in 1977. In this case, the company’s appeal came to the House of Lords on the basis that, although Chancery Lane applied, it had been wrongly decided. The company’s appeal was, however, dismissed on the grounds that the Chancery Lane decision was a correct application of the Revenue law, and that it
was, therefore, up to the Revenue to review their position. This case was probably instrumental in persuading the Revenue to reconsider this seemingly anomalous situation whereby varied accounting treatments of similar transactions resulted in different tax results. This may be summed up in the following extract from Lord Wilberforce's judgment:

'My Lords, it may be—I do not know—that a result which causes property companies which, as advised by their accountants, capitalise interest on investments or development, to suffer fiscally as compared with those who charge their interest payments to revenue, or, perhaps more accurately, do not decide to capitalise them, is unjust or economically unsound. But the remedy for this does not lie here. It is for the Revenue not merely to rest upon its victory, but to consider the broad merits or otherwise of the result, after such representations as the affected taxpayers may make.'

Nevertheless, the practice of capitalising interest on consolidation appeared unaffected by the case law; so the tax treatment depended not on whether interest was capitalised, but on how the capitalisation was presented in the financial statements. An inquiry was eventually set up by the Inland Revenue, leading to the 1981 Finance Act amendment which permitted capitalised interest to be charged to income for tax purposes. Also in 1981, the capitalisation of interest was referred to in company law for the first time, with the Companies Act 1981 making it clear that interest could be included in the production cost of an asset. Since 1981, the practice of capitalising borrowing costs has become increasingly common in the UK in other industries which have major fixed asset developments, such as supermarkets and hotels. However, there is still no UK accounting standard on the subject (although ED 51 — Accounting for fixed assets and revaluations — issued by the ASC in 1990 does deal with it in passing), so capitalisation remains optional, and accounting treatments varied and inconsistent.

In the US, the capitalisation of borrowing costs received renewed attention in the early 1970s, following the increased use of borrowed funds to finance business operations, coupled with a sharp rise in interest rates. Prior to that, it was predominantly the public utility companies which capitalised borrowing costs, with most other companies accounting for interest cost as a current period expense. In 1971, the Accounting Principles Board set up a committee to consider the subject; however, although the committee prepared a comprehensive working paper setting out the principal issues to be considered, its activities were terminated before a pronouncement could be issued. In 1974, the SEC became concerned about the growing popularity of interest capitalisation, when it noted an increase in the number of non-utility registrants that were adopting a policy of capitalising interest as part of the cost of certain assets. This was causing inconsistency between those companies whose earnings were boosted by capitalisation and others which expensed interest costs as incurred. In 1974, the SEC imposed a moratorium on companies adopting or extending a policy of