IAS 23 Borrowing Costs - A Closer Look

Muthupandian, K S

The Institute of Cost and Works Accountants of India

20 October 2009

IAS 23,
Borrowing Costs
- A Closer Look

K.S.Muthupandian*

International Accounting Standard (IAS) 23, *Borrowing Costs,* prescribes the accounting treatment for borrowing costs. In November 1982, the International Accounting Standards Committee (IASC) issued the Exposure Draft E24, *Capitalisation of Borrowing Costs*. In March 1984, the IASC issued IAS 23, *Capitalisation of Borrowing Costs,* effective from January 1, 1986. In August 1991, the IASC issued the Exposure Draft E39, *Capitalisation of Borrowing Costs*. In December 1993, the IASC issued IAS 23, *Borrowing Costs* (revised as part of the 'Comparability of Financial Statements' project based on E32), effective from January 1, 1995. In April 2001, the International Accounting Standards Board (IASB) resolved that all Standards and Interpretation issued under previous Constitutions continued to be applicable unless and until they were amended or withdrawn. On May 25, 2006, the IASB issued the Exposure Draft of proposed amendments to IAS 23. On March 29, 2007, the IASB issued revised IAS 23, *Borrowing Costs*. IAS 23 (2007) will be mandatory for annual reporting periods commencing January 1, 2009 and it does not permit the expensing of borrowing costs. IAS 23 (1993) permits the benchmark treatment of expensing borrowing costs relating to qualifying assets, and remains applicable under superseded. On May 22, 2008, IAS 23 amended for 'Annual Improvements to International Financial Reporting Standards (IFRSs) 2007'. The effective date of May 2008 amendment to IAS 23 was fixed as January 1, 2009.

Objective

The objective of IAS 23 is to prescribe the accounting treatment for borrowing costs. This standard requires the capitalisation of all borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

***M.Com., FICWA**
Email: ksmuthupandian@ymail.com / ksmuthupandian@gmail.com

Scope and Application

The standard shall be applied in accounting for borrowing costs but it does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.
The standard does not apply to borrowing costs directly attributable to acquisition, construction or production of:
• a qualifying asset measured at fair value; e.g. a biological asset
• inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis

Key Definitions

Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.
Borrowing costs may include:
(a) interest on bank overdrafts and short-term and long-term borrowings;
(b) amortisation of discounts or premiums relating to borrowings;
(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;
(d) finance charges in respect of finance leases recognised in accordance with IAS 17 *Leases;* and
(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Qualifying assets are assets that necessarily take a substantial period of time to get ready for their intended use or sale. Examples of qualifying assets are complex manufacturing plants, power generation facilities and infrastructure projects which are constructed over a few years.
Examples of qualifying assets are inventories that require a substantial period of time to bring them to a saleable condition, manufacturing plants, power generation facilities and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Prescribed Accounting Treatment

IAS 23 requires all borrowing costs capitalised as part of the cost of the asset, where the borrowing costs are directly attributable to the acquisition, construction or production of a qualifying asset.

Subject to the probability test that it will result in future economic benefits to the entity and the costs can be measured reliably.

Borrowing costs eligible for capitalisation

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is coordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset shall be determined as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

To the extent that funds are borrowed generally (e.g. use of a range of debt instruments which incur different rates of interest and lends those funds to other entities within the group), and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation shall be determined by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period shall not exceed the amount of borrowing costs incurred during that period.

In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

Excess of the carrying amount of the qualifying asset over recoverable amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other standards.

Commencement of capitalisation

The capitalisation of borrowing costs as part of the cost of a qualifying asset shall commence when:
• expenditures for the qualifying asset are incurred
• borrowing costs are being incurred
• activities that are necessary to prepare the asset for its intended use or sale are in progress

Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditures are reduced by any progress payments received and grants received in connection with the asset (see IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of capitalisation

Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out.

Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of capitalisation

Capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

A business park comprising several buildings, each of which can be used individually is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Prescribed Disclosures

Required disclosures include:

- the amount of borrowing costs capitalised during the period
- the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation

IASB-FASB Joint Short-term Project

Achieving convergence of accounting standards around the world is one of the prime objectives of the IASB. In pursuit of that objective, the IASB and the United States Financial Accounting Standards Board (FASB) have undertaken a joint short-term project with the aim of reducing differences between IFRSs and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside major projects. This short-term convergence project is considering whether and how to converge IAS 23 and FASB Statement No. 34 *Capitalization of Interest Cost* (SFAS 34).

IAS 23 and SFAS 34 prescribe the accounting treatment for borrowing costs:

> IAS 23 permits two possible treatments, either the capitalisation of borrowing costs, to the extent that are directly attributable to the acquisition, construction or production of a qualifying asset (as defined), or alternatively, immediately expensing the borrowing costs.
>
> SFAS 34 requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset (as defined). Immediate expensing is not an option.

Not only is the fundamental approach different between IFRS and US GAAP, how the two sets of standards define a 'qualifying asset' is quite different.

The staff paper explored whether the IASB should require capitalisation of interest on qualifying assets using what was termed an 'economic cost' model. In essence, this would result in an entity using the same discount rate as that used for testing for impairment in under the requirements of IAS 36, *Impairment of Assets* (a rate that reflects current market assessments of the risks specific to the asset being constructed). However, moving to this measurement approach would not result in convergence with US GAAP, unless the FASB agreed to adopt the same approach. The IASB was reminded that this was a proposal related to a short-term convergence project and that such projects usually concentrated on eliminating alternatives. Some Board members noted that even eliminating the expensing option in IAS 23 would not achieve convergence with US GAAP because the definition of qualifying asset was different between the two sets of standards. One possibility would be to work on the capitalising approach based on economic cost, seeing whether there was any appetite on behalf of the FASB for change to their standard. After a rather difficult debate, the IASB agreed to proceed with a short-term convergence project on IAS 23 that would eliminate the alternative of immediate expense (12 in favour; 2 opposed).

At the November 2005 IASB Meeting**,** the IASB agreed with a staff proposal that the amendment to IAS 23 should eliminate the immediate expense alternative in the current standard but should not propose to use the capitalisation method in the US standard. The reason for this is that the method in US GAAP is not seen as 'a higher quality solution' than the current capitalisation method in IAS 23.

For the January 2006 IASB meeting, the staff prepared a paper setting out how the transitional provisions for only allowing capitalising should be addressed for existing IFRS users as well as for first time adopters. The IASB decided to issue an exposure draft proposing that:

Existing IFRS users should apply the proposed amendments (required capitalisation) prospectively to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is after the effective date - with an option to apply the capitalisation amendments starting at any date selected before the effective date.

First-time adopters should have the same transition options as existing IFRS users (this will require amendment of IFRS 1, *First-time Adoption of IFRSs*).

At the March 2006 IASB Meeting, the IASB has decided to issue an Exposure Draft (ED) with an amendment to IAS 23 to remove the option to expense borrowing costs when they are incurred. The IASB agreed that this amendment should not be applied to borrowing costs directly attributable to the acquisition, construction or production of qualifying assets measured at fair value (such as biological assets). If this exception were not made, entities would be forced to capitalise interest costs on this assets, only to then write them back off again when remeasuring the assets to fair value.

May 2006 Exposure Draft

On May 25, 2006, the IASB published for public comment, an Exposure Draft of proposed amendments to IAS 23. The Exposure Draft would require an entity to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. The option to recognise immediately borrowing costs as an expense would be removed.

The IASB believes that the elimination of one of the two options in accounting for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset would improve financial reporting and would result in information that is more comparable between entities.

The proposed amendments eliminate the option in IAS 23 of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The IASB concluded that eliminating this option will improve financial reporting and will move closer to the recognition requirements of SFAS 34. The IASB has not reconsidered the other provisions of IAS 23.

At the November 2006 IASB Meeting, the Board discussed comments received on its ED of proposed amendments to IAS 23. A significant number of respondents expressed strong disagreement with the proposal in the ED to eliminate the option to expense as incurred. In light of comments received, the IASB discussed whether it should proceed with the publication of a final amendment to IAS 23 or terminate the project. The IASB was split on how to proceed based on the comments received. Due to the comments and the split view by Board members it decided that the staff should do further analysis on comments from respondents before the IASB decides how to proceed.

At the December 2006 IASB Meeting, the Board continued its redeliberations of planned amendments to IAS 23. In particular, the IASB discussed a staff recommendation that, notwithstanding the large-scale opposition from users, preparers, and other constituents, the IASB should proceed with the amendments substantially as exposed and eliminate the option to expense interest as incurred, thereby mandating the capitalisation method. The IASB voted by a majority of 10-4 to accept the staff recommendation and proceed with the amendments.

The IASB considered two amendments proposed by the staff. The first was whether the revised IAS 23 should provide an exception from the general principle for certain inventories. The issue was raised by a constituent in the whisky and wine-making industry, who noted that while the effect on profit and loss was minimal, the effect on the balance sheet would be material because the inventories must mature for several years. Board members noted that it was exactly these types of inventories that should include interest cost in their carrying amount. However, having decided to converge in principle with US GAAP, the IASB agreed to provide the same exception as in SFAS 34 paragraph 10, such that 'interest cost shall not be capitalized for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis'.

The IASB also considered whether to amend the scope of the revised IAS 23 to include assets that are carried at fair value (except those within the scope of IAS 41, *Agriculture*). The issue concerns 'geography' within the statement of profit and loss and how the fair value adjustment is recorded: as the total change in fair value from period to period or the change between items (such as interest) included in the historical cost carrying amount and the fair value. After debating this issue at some length, the IASB confirmed the position exposed in the ED (paragraph 3A) that there would be a scope exception for all assets measured at fair value, including biological assets.

March 2007 Revised Standard

On March 29, 2007, the IASB issued a revised IAS 23. The main change from the previous version is the removal of the option of immediately recognising as an expense borrowing costs that relate to assets that take a substantial period of time to get ready for use or sale.

The IASB believes that application of the revised Standard will improve financial reporting in three ways. First, the cost of an asset will in future include all costs incurred in getting it ready for use or sale. Second, comparability is enhanced because one of the two accounting treatments that previously existed for those borrowing costs is removed. Third, the revision to IAS 23 achieves convergence in principle with US GAAP.

The revision to IAS 23 removes the option of immediately recognising as an expense borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. A qualifying asset is one that takes a substantial period of time to get ready for use or sale. An entity is, therefore, required to capitalise such borrowing costs as part of the cost of the asset.

The revised Standard does not require the capitalisation of borrowing costs relating to assets measured at fair value, and inventories that are manufactured or produced in large quantities on a repetitive basis, even if they take a substantial period of time to get ready for use or sale.

The revised Standard applies to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after January 1, 2009.

Interpretation

The Standards Interpretations Committee (SIC) of the IASC has issued the following Interpretation relating to IAS 23:

- SIC 2, *Consistency – Capitalisation of Borrowing Costs* (issued in December 1997 and superseded by IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*)

Comparative Indian Standard

The Accounting Standard issued by the Institute of Chartered Accountants of India (ICAI) comparative to IAS 23 is AS 16, *Borrowing Costs.* There is no major difference between AS 16 and IAS 23 (2007). However, the following point in recognition of borrowing costs may be noted:

In IAS 23, the borrowing costs are expensed as incurred (not permitted for qualifying assets for which the capitalisation date falls in annual periods beginning on or after January 1, 2009); or capitalized if these costs are attributable to the acquisition, construction or production of a qualifying asset. In AS 16, the borrowing costs are required to be capitalized if these costs are attributable to the acquisition, construction or production of a qualifying asset. Recognising these as an expense when incurred is not permitted.

Conclusion

The revised IAS 23 continues the work of the IASB to eliminate major differences between IFRSs and US GAAP and to improve financial reporting. The removal of the option of immediately recognising as an expense in IAS 23 improves comparability and converges in principle with US GAAP.

****