Move Forward International

# IFRS Training

## IAS 23 – Borrowing Costs

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Professional Training Services

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## Section 1

Overview

# Overview

- Entities borrow in order to **finance their activities** and they incur **interest** on the amounts borrowed

- A point of contention in determining the initial measurement of an asset is whether or not finance costs incurred during the period of its construction should be capitalized

*How should **debits** be recognized in the financial statements?*

Always as an **expense**

Are there circumstances which justify **capitalization** as an asset?

## Section 2

Arguments

# Arguments for Capitalization of Interest

| Accruals | Comparability | Consistency |
| --- | --- | --- |
| • Better matching of cost (interest) to benefit (use of asset) | • Is improved<br>• Better comparison between entities which buy the assets and those which construct | • Interest is treated like any other production costs |

# Arguments against Capitalization of Interest

| Accruals | Comparability | Consistency | Finally |
| --- | --- | --- | --- |
| • Cost should be reflected in the SOCI in period for which the entity has the use of cash | • Is distorted<br>• Similar assets held at different costs depending on the method of finance-distorted | • Interest is treated differently from period to period – depending on what borrowing is used for | • Reported profit distorted |

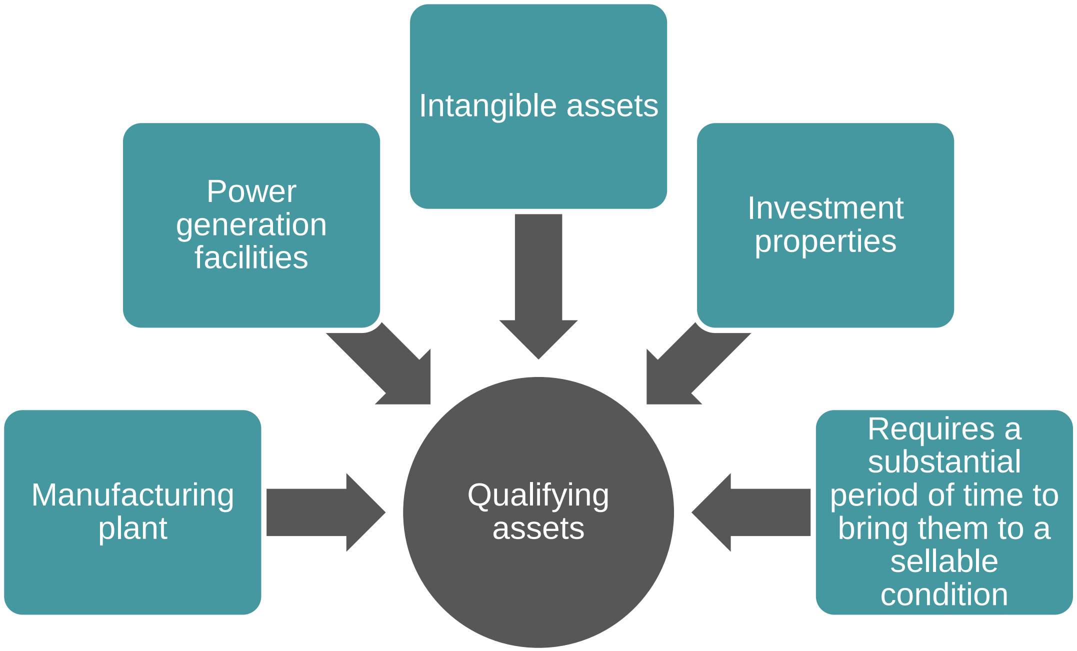
# Section 3

Scope and Definitions

# Qualifying Asset

Judgmental

*A **qualifying asset** is an asset that necessarily takes a **substantial period of time** to get ready for intended use or sale*




**Qualifying assets do not include assets ready for their intended use or sale when acquired**

- ✓ An asset that normally takes 12 months or more to be ready for its intended use will usually be a qualifying asset

# Definition

Borrowing costs form part of the cost of **qualifying asset** if they are directly attributable to its:

Acquisition

Construction

Production

# Definition (Continued)

- ✓ Interest and other costs incurred in connection with the borrowing of funds. They may include:
  - ❑ Interest expense calculated using the **effective interest method** based on IAS 39
  - ❑ Finance charges in respect of **finance leases**
  - ❑ Exchange differences arising from **foreign currency borrowings** to the extent that they are regarded as an adjustment to interest costs

# Core Principle

- ✓ Assets that are ready for their intended use or sale when acquired are not qualifying assets
- ✓ All borrowings costs that relate to a qualifying asset must be capitalized into the cost of that asset; all other borrowing costs should be recognized as an expense in the period in which they are incurred
- ✓ IAS 23 excludes all financial assets from the definition of qualifying assets

# Inventories

- **Inventories** are within scope of IAS 23 as long as they meet the definition and require a substantial period of time to bring them to a sellable condition (such as aircraft and large items of equipment or food and drink that take a long time to mature, such as  cheese or alcohol that matures in bottle or cask

- 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. Therefore capitalization need not applied

- Qualifying assets **measured at fair value** (such as biological assets) are not qualifying assets

# IAS 16



- ✓ IAS 23 does not require entities to capitalize interest relating to assets measured at fair value that would be otherwise be qualifying assets

- ✓ If the assets held under fair value model with all changes going to profit or loss, then capitalization would not affect measurement in the statement of financial position and would involve no more than reallocation between finance costs and the fair value movement in profit or loss. However, this scope exemption is optional and would still allow an entity to choose whether to apply the requirements of IAS 23

- ✓ Assets measured at fair value that falls under the revaluation model of IAS 16 are also eligible for this scope exemption of IAS 23 even though the revaluation gain or loss goes to OCI and not profit or loss

- ✓ It is worth mentioning that the revaluation model under IAS 16 is only applied subsequent to initial recognition. Therefore, such assets might be qualifying assets at initial recognition, but subject to the scope exemption subsequently

## Section 4

Capitalization

# Capitalization

- **Directly attributable** borrowing costs are those that would have been avoided if the expenditure on the qualifying asset had not been made

- Borrowing costs that are directly related can be readily identified if an entity borrows funds specifically for the purpose. In this case, the borrowing costs eligible for capitalization are the actual borrowing costs incurred during the period **(no problem)**

- As entities frequently borrow funds in advance of expenditure on qualifying assets, any **investment income on the temporary investment** of those borrowings should be deducted and only the net amount capitalized. Such investment in which the funds can be invested must ne specific borrowings and must be of a nature that does not expose the principal amount to the risk of not being recovered. The more risky the investment, the greater is the likelihood that the borrowing is not specific to the qualifying asset. If the investment returns a loss rather than income, such losses are not added to the borrowing costs to be capitalized

# Capitalization (Continued)

- ✓ IAS 23 admits that there may be **practical difficulties** in identifying a direct relationship between particular borrowings and qualifying assets and in determining the borrowings that could otherwise have been avoided
  - ❑ An entity has a group treasury function that 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
  - ❑ Borrowings in foreign currency when the group operated in a highly inflationary economy
- ✓ Then:
  - ❑ Apply a capitalization rate
  - ❑ Capitalization rate = weighted average cost of non-specific borrowings for the period
  - ❑ For a period , the amount capitalized should not exceed borrowing costs incurred
- ✓ Weighted average may be calculated at group or individual subsidiary level

# Accrued Costs

- IAS 23 states that expenditure on qualifying assets includes only that expenditure resulting in the payment of cash, the transfer of other assets or the assumption of interest bearing liabilities

- Therefore, costs of a qualifying assets that have only been accrued but have not yet been paid in cash should be excluded  from the amount in which interest is capitalized

# Gain and losses on De-Recognition

- ✓ If an entity repays borrowings early, in whole or in part, then it may recognize a gain or a loss on the early settlement, such gain or loss include amounts attributable to expect future interest rates; in other words, it includes an estimated prepayment of the future cash flows under the instrument. The gain or loss is a function of relative interest rates and how the interest rate of the instrument differs from current and anticipated future interest rates. There may be circumstance in which a loan is repaid while the qualifying asset is still under construction. IAS 23 does not address the issue

- ✓ In our view, gains and losses on de-recognition of borrowings are generally not eligible for capitalization. It would be extremely difficult to determine an appropriate amount to capitalize and it would be inappropriate thereafter to capitalize any interest amounts (on specific or general borrowings) if doing so would amount to double counting. Decisions to repay borrowings early are not usually directly attributable to the qualifying asset but to other circumstances of the entity

- ✓ The same approach would be applied to gains and losses arising from a refinancing when there is a substantial modification of the terms of borrowings

# Borrowing in Entity and Development in …

- ✓ A question that often arises in practice is whether it is appropriate to capitalize interest in the group financial statements on borrowings that appear in the financial statements of a different group entity from the carrying out the development, Based on IAS 23, capitalization in such circumstances would only be appropriate if the amount is capitalized fairly reflected the interest cost of the group on borrowings from third parties that could have been avoided if the expenditure on the qualifying asset were not made

- ✓ Although it may be appropriate to capitalize interest in the group financial statements, the entity carrying out the development should not capitalize any interest in its own financial statements as it has no borrowings

- ✓ If, however, the entity has intra-group borrowings then interest on such borrowings may be capitalized in its own financial statements

# Section 5

Commencement , Suspension and Cessation of Capitalization

# Commencement of Capitalization

- IAS 23 requires that capitalization should **commence** when:
  - Expenditures of the asset are being incurred
  - Borrowing costs are being incurred
  - Activities that are necessary to prepare the asset for intended use or sale are in progress
- IAS 23 makes it explicit that only those **expenditures** on a qualifying asset that have resulted in:
  - Payments for cash
  - Transfer of other assets
  - The assumption of interest-bearing liabilities

# Commencement of Capitalization (Cont'd)

- Expenditures must be reduced by any progress payments (IAS 11) and grants received in connection with the asset

- Necessary activities can start before the **commencement** of physical construction and include, for example, technical and administrative work such as obtaining permits

- Note that this does not mean that borrowing costs can be capitalized if it is unclear that permits that are necessary for the construction will be obtained. No cost could be considered directly attributable prior to this point. However, interest may not be capitalized during a period in which there are no activities that change the asset condition

- Borrowing costs incurred while land is under development are capitalized 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 capitalization

# Suspension of Capitalization

- ✓ During extended periods in which active developments is interrupted
- ✓ Capitalization is not normally **suspended** when:
  - ❑ Substantial technical and administrative work is being carried out
  - ❑ A temporary delay is necessary in getting an asset ready (construction of a bridge delayed by temporary weather issues in a place where such conditions are routine)
- ✓ Capitalization continues during periods when inventory is undergoing slow transformation (presumably such products as scotch whisky and Cognac

# Cessation of Capitalization

- ✓ When substantially all the activities necessary to prepare the asset are complete
- ✓ Normally when the physical construction of the asset is complete
- ✓ When the construction is completed in parts and substantially all the activities necessary to prepare that part are completed

## Section 6

Disclosure

# Disclosure

- ✓ The amount of borrowing costs capitalized during the period
- ✓ The capitalization rate used to determine the amount of borrowing costs eligible for capitalization