ISSUES ON CAPITALISATION OF BORROWING COSTS

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Abstract: *IAS 23 Borrowing Costs prescribes the accounting when borrowings are made to acquire or construct an asset. The core principle of the standard is that borrowing costs that are directly attributable to the acquisition or construction of a qualifying asset must be capitalised. Even though in theory this principle seems simple to apply, its practical implementation often raises questions for which IAS 23 doesn't give clear guidance. Challenges in applying this standard are related to specific issues such as identifying the qualifying assets, calculating the total borrowing costs eligible for capitalisation, when to start or to suspend capitalisation, borrowing costs in separate and consolidated financial statements. Some of these practical challenges are discussed in this article.*

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1. Introduction

Entities borrow funds in order to finance their investment activities that consist in acquiring, constructing and producing different types of assets. In some cases, the construction process for certain assets may be longer and therefore it may take a long period of time before the assets are ready for their intended use or for sale. During this time entities that take loans to finance the completion of the asset incur interest on the amounts borrowed.

IAS 23 Borrowing costs addresses accounting for borrowing costs. Borrowing costs are defined as interest and other costs that an entity incurs when borrow funds. The core principle of the standard is that only those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised. All other borrowing costs are expensed as incurred (IAS 23, par. 8).

2. Borrowing costs

According to IAS 23, borrowing costs consist in interest and other costs incurred in connection with the borrowing of funds.

Several aspects need to be considered regarding the borrowing costs.

Interest on short term loans or long-term debts, calculated using the effective interest method, should be included as part of borrowing cost. According to *IFRS 9 Financial Instruments*, the effective interest method is the method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

The effective interest method takes into account all the fees and points paid or received that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

The result of applying this method is to allocate interest expense over the relevant periods by producing a periodic interest expense equal to a constant percentage of the carrying amount of the liability. This means that transaction costs and fees are amortised over the life of the loan and are included in the interest expense.

For example, if an entity incurred CU 100 legal fees to raise a CU 10,000 loan that bears interest at the fixed rate of 10% per year, the borrowing costs are the interest on the loan and the amortisation of the legal fees. The entity accounts for the loan at amortised cost and the amortised cost requires the transaction costs of CU 100 to be included in the

initial measurement of the liability and recognised over the life of the loan using the effective interest method.

If an entity has acquired any asset under finance lease or any other similar arrangement, then those finance costs are also a part of borrowing cost.

If an entity has taken any borrowing in foreign currency, then the exchange rate fluctuation is also amortised to the extent this is regarded as an adjustment of interest costs. The gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency and borrowing costs actually incurred on foreign currency borrowings. For determining the borrowing costs, the entity has to determine what portion of foreign exchange differences arises due to the differential between the interest rates in two countries and, thus, represents an adjustment to interest costs (PWC, 2015, pp. 10).

IAS 23 does not contain references about certain types of expenses, not being clear whether they are borrowing costs or not, for example dividends payable on preference shares (or other types of shares classified as liabilities) or gains or losses arising from early repayment of borrowings, etc.

Also, IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability. Accordingly, where a financial instrument has been classified as equity in accordance with *IAS 32 Financial Instruments: Presentation* the costs of servicing the equity instrument cannot be capitalised.

Because cost of equity is not capitalised, comparability between assets is achieved only for those assets that are financed with loans (not those financed with equity or by a combination of both) (Grant Thornton, 2009, pp. 10). The capital structure of an entity may affect the reported cost of a qualifying asset, the cost of the assets being different depending of the financing structure of the entities. The conclusion is that capitalisation of borrowing costs may result in different costs being attributed to identical assets, depending on whether the asset's acquisition, construction or production was financed by debt or equity or a combination of both (European Commission, 2008, pp. 7).

Additionally, if an entity has no loans and uses its own cash resources to finance the construction of an asset, cash being used for this investment could otherwise have been used to earn interest. The opportunity cost of the cash used for financing the asset's construction cannot be capitalised as a borrowing cost (PWC, 2008, pp. 8).

3. Qualifying assets

A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. IAS 23 does not define the term ‘substantial period of time’. Management exercises judgement when determining which assets are qualifying assets, taking into account several factors, such as the nature of the asset or the manufacturing technology. An asset that normally takes more than one year to be ready for use is usually a qualifying asset. Once the criteria are determined, they have to be applied consistently to all types of assets.

For example, inventories are within the scope of IAS 23 when they meet the definition and require a substantial period of time to bring them to a sellable condition (e.g. aircrafts, ships or large items of equipment but also food and drink that take a long time to mature, such as certain types of cheese or alcoholic beverages). Inventories that are manufactured or produced in large quantities on a repetitive basis over a short period of time are not qualifying assets.

IAS 23 states that the assets that are ready for their intended use or sale when acquired are not qualifying assets. Therefore management intention has to be taken into consideration when assessing whether an asset is a qualifying asset. At the date of

acquisition management should assess whether an asset is 'ready for its intended use or sale'. The asset might be a qualifying asset, depending on how management intends to use it. For example, when an acquired asset can be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

IAS 23 does not require entities to capitalise the borrowing costs related to assets measured at fair value that would be otherwise qualifying assets. If the assets held under fair value model with all changes going to profit or loss, then capitalisation would not affect measurement in the statement of financial position and would involve only a reallocation between finance costs and the fair value movement in profit or loss. Assets measured at fair value that falls under the revaluation model according to *IAS 16 Property, Plant and Equipment* are also eligible for this scope exemption of IAS 23 even though the revaluation gain or loss goes to other comprehensive income. Still, the revaluation model under IAS 16 is only applied subsequent to initial recognition therefore such assets may be qualifying assets at initial recognition, but subsequently they may be the subject to the scope exemption of IAS 23 (MFI, 2016, pp. 14).

4. Capitalisation of borrowing costs

The amount of borrowing costs that is capitalised is the interest cost of funds borrowed to finance the acquisition or construction of a specific asset, or a proportion of the funds borrowed by the entity for general use, using a weighted average cost of finance, in case that it is not possible to link specific funds borrowed with a specific qualifying asset.

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 (IAS 23, par. 18). Therefore, costs of 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 capitalised.

Borrowing costs that satisfy the 'directly attributable' criterion are generally those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. In case that an entity borrows funds generally, the borrowing costs are not always readily attributable to a qualifying asset.

IAS 23 does not define the terms 'specific borrowing' and 'general borrowing'.

Generally speaking, en entity takes a specific borrowing only for the purpose of financing the construction, acquisition or production of a qualifying asset, whereas general borrowings are loans for general purposes, like as buying inventory, paying off creditors and other purposes, additionally to the construction, acquisition or production of a qualifying asset.

The particular circumstances should be considered when management decides whether the borrowing is specific or general. For example, a bank overdraft facility is often used as general purpose borrowings, but it is also possible for a bank overdraft facility to be arranged specifically for a qualifying asset.

If an entity borrows funds specifically for the purpose of obtaining a qualifying asset, management determines the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period, less any investment income on the temporary investment of those borrowings, according to IAS 23.

The investment income on the temporary investment of the amount borrowed is deducted and only the net amount is capitalised. Such investment in which the funds can be invested must be 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 probability 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 capitalised (MFI, 2016, pp. 16).

For example, on 1st March 201X, Company AAA took a bank loan of CU 510,000 at the interest rate of 10% per year for financing the construction of a storage facility; the loan is repayable after one year. The construction started on 1st May 201X. The entity invested CU 500,000 from the borrowed amount for one month - May - at the rate of 4% per year.

Although the bank loan was contracted on 1st March, the capitalisation starts on 1st May 201X when all criteria were met. The interest in March and April 201X was expensed in profit or loss, as the capitalisation criteria were not met in that period.

Total borrowing cost that is capitalised in 201X is calculated as follows:

- Interest expense: CU 510,000 x 10% x 8/12 = CU 34,000
- Less investment income: CU 500,000 x 4% x 1/12 = CU 1,667
- Total borrowing cost that is capitalised in 201X: CU 32,333

There are specific situations in which a qualifying asset is financed by a combination of bank loans that are specific to the asset and by general borrowings. In this case, management determines the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. IAS 23 requires that this rate to be calculated as 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 (IAS 23, par. 14).

For example, entity BBB took out the following loans in 201X: a bank loan of CU 300,000 at 12% per year and another one of CU 400,000 at 10% per year which were taken for no specific purpose and BBB used them to finance general spending and the production of new equipment.

BBB used CU 250,000 for the construction of the equipment on 1st March 201X and CU 300,000 on 1st July 201X.

The capitalisation rate is the calculated as a weighted average of the borrowing costs applicable to the general borrowings that were taken by the entity BBB.

The borrowing cost that is capitalised for the new equipment in 201X is calculated as follows:

- Weighted average rate = *((12% x 300,000) + (10% x 400,000))/(300,000 + 400,000)* = 10.86%
- Borrowing costs to be capitalised for the new equipment in 201X = *CU 250,000 x 10.86% x 10/12 + CU 300,000 x 10.86% x 6/12* = CU 38,915

Measuring the borrowing costs to be capitalised is more complicated when the borrowing is not a loan of a precise amount but a bank overdraft that increases as expenditure is paid for. If the borrowing is a precise amount, the capital sum is used for calculation of the capitalised borrowing costs. If the borrowing is a fluctuating amount (e.g. an overdraft) the calculation is based on the amount of the relevant expenditures and depends when they were incurred.

In assessing whether the expenditures (on which interest is incurred) are incurred evenly or at the beginning or end of a period or at different times during a period, the following matters have to be taken into consideration:

- if the costs are incurred evenly, interest expense should be measured using average borrowing balances; and
- if the costs are incurred at the beginning or end of a period, actual borrowing balances should be used (whether specific or general borrowings) (Kolitz, D.L., Sowden-Service, C.L., 2008, pp. 371-372).

An entity begins to capitalise borrowing costs on the commencement date which is when three conditions are met:

(i) it incurs expenditures for the asset;

(ii) it incurs borrowing costs for the asset; and

(iii) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

Sometimes, necessary activities may start before the commencement of physical construction and include, for example, technical and administrative work such as obtaining permits. In this situation, the borrowing costs can be capitalised only if it is clear that the necessary permits for the construction will be obtained. No cost could be considered directly attributable prior to this point.

An entity suspends capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

An entity ceases to capitalise borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

5. Conclusions

Some of the arguments in favour of capitalising the borrowing costs are the following:

• a better matching of cost (interest) to benefit (use of asset); the borrowing costs are more accurately matched to future revenues when they are depreciated as part of the cost of the asset. IAS 23 is considered a classic example of the accruals/matching concept;

• in the historical cost basis the capitalisation of borrowing costs and their inclusion in the cost of the assets is a better conceptual approach than the expensing of borrowing costs;

• a better comparison between entities which buy the assets and those which construct, and

• the interest is treated like any other production costs, thus the cost of the asset is more accurately measured by the inclusion of borrowing costs.

One argument against capitalising the borrowing costs is that the capitalisation results in different costs being attributed to assets, that are otherwise identical, depending on whether the asset's acquisition, construction or production was financed by debt, equity or a combination of both. In this case the costs of the assets are different depending of the financing structure of the entities. Comparability is distorted as similar assets are measured at different costs depending on the method of finance.

If the expensing method were applied, the comparability would be increased between assets that are equity financed and those that are debt financed, as no financing cost is included in the cost of the asset.

Additionally, interest is treated differently from period to period, depending on what borrowing is used for, that is why the reported profit is distorted.

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