IFRS Training

IAS 23 – Borrowing Costs

www.ccsintl.net

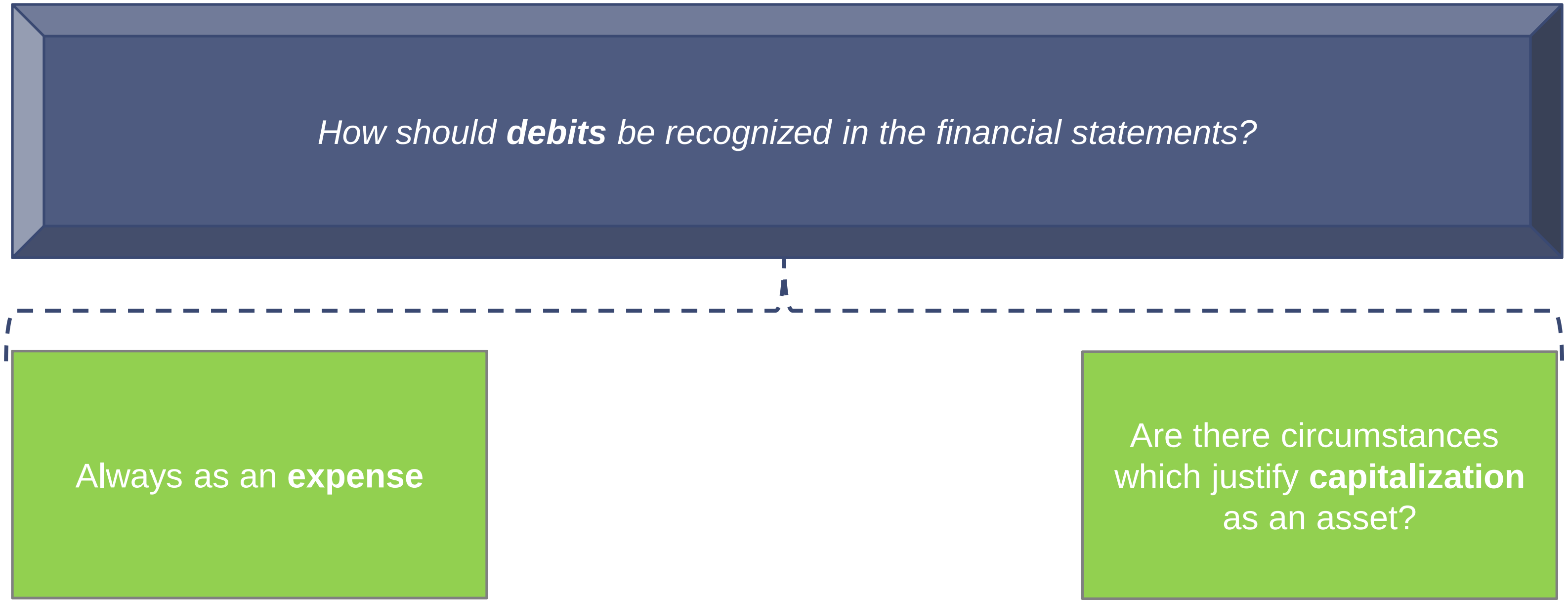
Table of Contents

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



Section 2

Arguments

Arguments for Capitalization of Interest

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

Arguments for Capitalization of Interest

Accruals

- Cost should be reflected in the SOCI in period for which the entity has the use of cash

Comparability

- Is distorted
- Similar assets held at different costs depending on the method of finance-distorted

Consistency

- Interest is treated differently from period to period – depending on what borrowing is used for

Finally

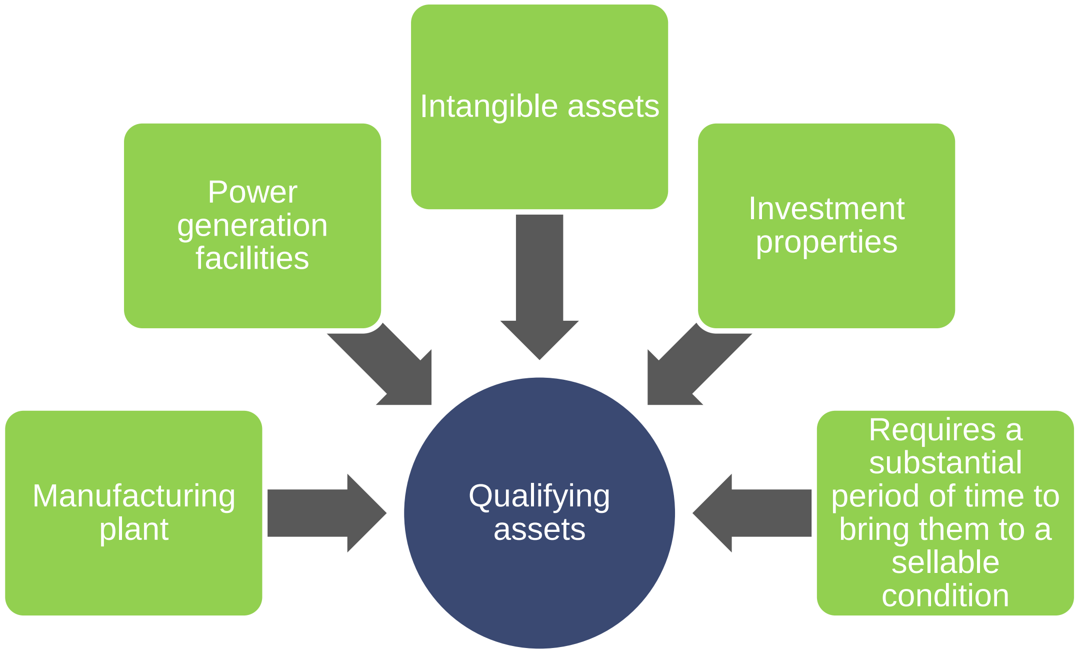
- Reported profit distorted

Section 3

Scope and Definitions

Definitions

*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

Definitions

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

- Acquisition
- Construction
- Production

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

Scope

- ✓ **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

- ✓ 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

Definitions

- ✓ 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

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

Capitalization

- ✓ 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

Capitalization

- ✓ 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

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

- ✓ 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

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