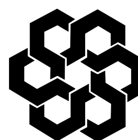

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: **12 December 2006, London**

Project: **Short-term convergence: Borrowing Costs**

Subject: **Comment letter analysis (Agenda Paper 7)**

Introduction

1. At the November meeting, the staff presented a paper that analysed comments received relating to question 1 of the Exposure Draft. The question asked whether or not constituents agreed with the Board's proposal to remove the option of recognising immediately as an expense borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset[1]. The Board asked the staff to prepare further analysis of arguments and suggestions made by respondents.

2. This paper presents a summary of respondents' arguments against the Board's proposals, and an analysis of respondents' suggestions on the direction of the project, to help the Board decide the best way forward.

3. An appendix sets out other issues raised by respondents (not planned for discussion unless a Board member wishes to raise them at the Board meeting).

[1] Hereafter, referred to as borrowing costs

4. In the staff's view, the underlying conceptual argument in this project is straightforward. If borrowing costs incurred to fund the construction of an asset are part of its cost, there is no basis for excluding those costs. We would not exclude the allocated costs of labour or overhead on a self-constructed asset, simply because capitalisation requires an allocation. If borrowing costs are not part of the asset's cost, there is no basis for capitalising them.

5. Following on this analysis, the staff notes the interaction between this project and the IFRIC's on Service Concessions. If borrowing costs are part of the historical cost of an intangible asset created in a project to build and operate, say, a bridge or toll road, how can they be expensed in other situations?

6. The staff agrees that costs of equity financing might also be a candidate for capitalisation, but doing so would open new conceptual ground. There is no broadly accepted way to measure the cost of equity financing ("cost of capital" computations often produce a range of measures). Moreover, we lack a framework for discussing cost of equity financing in a historical-cost system.

7. Finally, the staff observes that expensing borrowing costs damages comparability because a company can capitalise indirectly by having a contractor do the borrowing. A company choosing to expense borrowing costs should, in principle, be required to extract those costs from any contractor-financed project.

Staff Recommendations

8. The staff recommends that the Board should finalise Amendments to IAS 23 (see paragraph 21 of the paper), with two changes made to the Exposure Draft, as follows:

   a. Exclude from the scope of IAS 23 inventories that are routinely manufactured (see paragraphs 24—26).

   b. Include in the scope of IAS 23 assets that are measured at fair value, except those that are measured at fair value in accordance with IAS 41 *Agriculture* (see paragraphs 27—30).

Respondents' arguments against the Board's proposals

Not short-term convergence

9. Many respondents are of the view that the Board should not address borrowing costs as part of short-term convergence. They argue:

    a. that capitalisation of costs is a measurement issue. Some do not consider borrowing costs to be of such importance that it requires consideration before the discussion of measurement bases as part of the Conceptual Frameworks project.

    b. whether or not to capitalise borrowing costs is a difficult conceptual issue that deserves a proper debate. The divergence of views expressed in the development of both IAS 23 and SFAS 34 regarding the principle and the specific requirements indicate that the debate has not been concluded.

10. However, in support of the Board's proposals, the staff notes that the Board has concluded that capitalising borrowing costs is part of historical cost as defined in the *Framework* and accordingly, has proposed to make a change to IAS 23 at this time. The Board argued that work on standards cannot wait for the completion of discussions on the conceptual frameworks project before progressing.

Convergence with US GAAP

11. Many respondents criticise the Board for addressing only one of the differences between IAS 23 and SFAS 34, whilst ignoring all of the other differences in the capitalisation methods required by both standards[2]. They think that convergence on the principle of capitalisation does not result in any benefit either to users of financial statements or to preparers (whether or not they are required to prepare a US GAAP reconciliation).

12. In support of the Board's proposals, the staff argues that the project does not aim to achieve full convergence on all aspects of accounting for borrowing costs. The Board has indicated its general intention of removing major differences between IFRS and US GAAP. It is not therefore appropriate for the

[2] Differences remain in relation to the definition of borrowing costs, the definition of qualifying assets, measurement, and the commencement and suspension of capitalisation.

Board to spend time and resources considering aspects of IAS 23 beyond the choice between capitalisation and immediate recognition as an expense.

Comparability

13. Some respondents challenge the Board's assertion in the Basis that the proposals will enhance comparability between assets that are internally developed and those acquired from third parties. Many highlight the lack of comparability of similar assets when the capital structure of entities is different. Others view an internally developed asset as an economically different transaction to a purchased asset.

14. In support of the Board's proposals, the staff notes that the removal of an option of accounting treatment and convergence in principle with US GAAP will enhance comparability. Whilst capitalising borrowing costs does not achieve comparability among liability financed and equity financed assets, it achieves comparability among all non-equity financed assets, which is better than the current position. Indeed, some staff argue that so few assets now are equity financed that capitalisation of borrowing costs achieves almost total comparability.

Cost to implement a policy of capitalising borrowing costs

15. Many respondents argue that the costs of implementation will be burdensome. Others anticipate problems with the method of calculation in IAS 23, and also in SFAS 34, noting that both standards were developed some years ago and need updating.

16. In support of the Board's proposals, the staff has spoken to a number of preparers that have capitalised borrowing costs for some time. Those preparers apply the requirements for capitalisation in IAS 23 without difficulty. Whilst there may be some specific issues of difficulty, the staff is not convinced that the cost of capitalising borrowing costs is excessive.

Not consistent with other IASB projects

17. Some respondents are of the view that the proposal is not consistent with the Board's approach on other projects. In particular, respondents refer to the Business Combinations II project (the requirement to expense transaction costs) and the Financial Statement Presentation project (the separation of an entity's financing activities from its business and other activities).

18. In support of the Board's proposals, the Business Combinations II project uses a fair value measurement basis, rather than historical cost. The staff also views transaction costs of a business combination to be different from borrowing costs incurred in constructing or producing a qualifying asset. Borrowing costs are part of the historical cost **of the asset acquired**, while transaction costs are not.

Benefit for users

19. A number of respondents disagree with the proposals because in their opinion, it will not improve the quality of information provided to users of financial statements. All four users who responded to the Exposure Draft disagree with the proposals, as do members of the Analyst Representatives Group. Some of those users expressed the view that assets should be measured initially at fair value in order to achieve full comparability—as that could not be achieved in the short-term, the Board should do nothing at present. Others (in particular, credit analysts) suggested removing the option to capitalise borrowing costs if the Board's intention was to remove an accounting option. Others suggested requiring the capitalisation of an economic interest cost. All of these suggestions are addressed later in the paper.

Respondents' suggestions on the direction of the project

20. Respondents to the Exposure Draft and made the following suggestions on the direction of the project

    a. Publish Final Amendments to IAS 23 (paragraphs 21—32)

    b. Do nothing at present and discuss with the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) (paragraphs 33—34)

c. Require the capitalisation of an economic interest cost (paragraphs 35—37)

d. Remove the option of capitalising borrowing costs (paragraphs 38—39)

e. Publish SFAS 34 *Capitalization of Interest Cost* (paragraphs 40—41)

Publish Final Amendments to IAS 23

21. Some respondents agree with the Board's proposals and suggest that the Board publish Final Amendments to IAS 23. The main arguments given by respondents for finalising Amendments to IAS 23 are as follows:

    a. The capitalisation of borrowing costs is part of historical cost as defined by the *Framework*—immediate expensing of borrowing costs does not give a faithful representation of cost. Removing an option in accounting treatment and converging in principle with US GAAP improves comparability. Whilst capitalisation of borrowing costs does not achieve comparability between liability financed and equity financed assets, it achieves comparability between all non-equity financed assets, which is better than the current position.

    b. The removal of the option in IAS 23 achieves a goal in the Memorandum of Understanding (MOU) between the FASB and the IASB, and demonstrates the IASB's commitment to the process of eliminating the IFRS US GAAP reconciliation requirement of the SEC.

22. The Board could take a number of approaches in finalising the Amendments, as follows:

    a. Publish Final Amendments as exposed

    b. Exclude inventories that are routinely manufactured

    c. Amend the scope to include assets that are carried at fair value, except those within the scope of IAS 41 *Agriculture*

    d. Include additional guidance on the capitalisation model

Publish Final Amendments as exposed

23. The project is a short-term convergence project. Accordingly, the Board has focused on removing major differences between IFRS and US GAAP on borrowing costs. It decided not to spend time changing the detail of the standard, which would extend the timing of the project beyond that envisaged by short-term convergence.

Exclude inventories that are routinely manufactured

24. [One respondent] raised concern about capitalising borrowing costs on inventories that are routinely manufactured. "[The respondent] has substantial whisky and wine inventories which are held for some years for maturation…For companies that have repetitive ongoing capital expenditure, the effect on net income will be minimal but the interest capitalised on the balance sheet may be material. Detailed records would have to be maintained for interest rates in different countries for different periods creating additional work to accurately maintain the records….interest capitalisation on inventories would create a huge administrative burden…[the amendments] will create a large reconciling item between [the respondent]'s IFRS and US GAAP results".

25. SFAS 34 excludes from its scope inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis "because, in the Board's judgment, the informational benefit does not justify the cost of doing so."[3] SFAS 34 acknowledges the difficulty in allocating borrowing costs to assets that do not involve a discrete project, such as inventories that are routinely manufactured. For example, a whisky manufacturer may hold inventory for up to 30 years. The quantity of each type of whisky held is continuously added to and taken from. Therefore, the staff agrees with the comments made that it would be extremely burdensome to allocate borrowing costs to such inventory. In addition, it is questionable how useful the information would be to users. [The respondent] notes that "as there is a constant flow of product into and out of inventory the effect on net income would generally not be significant. In times of reducing interest rates to explain

[3] SFAS 34 paragraph 10

why cost of sales are increasing because of high interest rates a number of years ago would be extremely confusing and not particularly informative."

26. The staff recommends that the scope of IAS 23 excludes inventories that are routinely manufactured for the reasons noted above. The recommendation would also achieve convergence with SFAS 34 on this issue.

Amend the scope to include assets that are carried at fair value, except those within the scope of IAS 41

27. In the Exposure Draft, the Board proposed limiting capitalisation of borrowing costs to qualifying assets measured on a cost basis, noting that the amount of borrowing costs incurred does not affect the measurement of an asset carried at fair value. When discussing the issue before publishing the Exposure Draft, the staff considered the balance sheet effect and concluded that it would be pointless to capitalise borrowing costs if those costs do not affect the carrying amount of an asset measured at fair value.

28. The staff had not considered the effect on the income statement. By excluding assets measured at fair value, borrowing costs are not reported consistently. An entity using the cost model would report lower borrowing costs than entities that are not permitted to capitalise these costs for similar assets because they use fair value. In addition, the exclusion of assets measured at fair value conflicts with the Board's conclusion that borrowing costs are part of the cost of an asset. It also conflicts with accounting for subsequent expenditure[4] on assets measured at fair value in accordance with IAS 40 and revalued in accordance with IAS 16. B40 of IAS 40 states "some believe that there is no need to capitalise subsequent expenditure in a fair value model and that all subsequent expenditure should be recognised as an expense. However, others believe—and the Board agreed—that the failure to capitalise subsequent expenditure would lead to a distortion of the reported components of financial performance. Therefore, [IAS 40] requires that an entity should determine whether subsequent expenditure should be capitalised using a test similar to the test used for owner-occupied property in IAS 16."

[4] For clarification: borrowing costs incurred during the construction or production of a qualifying asset are not expenditure subsequent to the initial recognition of the asset *as available for use or sale* (when construction or production is complete). Rather, those borrowing costs are expenditure subsequent to the asset being first recognised.

29. To illustrate, consider an entity that redevelops an investment property measured at fair value in accordance with IAS 40. The investment property is valued at CU1,000,000 at the beginning of the year. During the year, the entity incurs redevelopment costs (labour, materials and overheads) of CU400,000, which is financed specifically by a bank loan. The entity incurs bank interest on the loan of CU22,000. The investment property is valued at CU1,500,000 at the end of the year.

Entries in the income statement as proposed in the Exposure Draft

The entity recognises fair value gains on investment property of CU100,000 and finance costs of CU22,000. The fair value gains represent the movement in fair value during the year (CU500,000) less any redevelopment costs (CU400,000), excluding borrowing costs. If borrowing costs are part of the cost of an asset, similar to any other costs, it would appear inappropriate to treat those costs differently.

Entries in the income statement as proposed by the staff in this paper

The entity recognises fair value gains on investment property of CU78,000 and finance costs of CU0. The fair value gains represent the movement in fair value during the year (CU500,000) less any redevelopment costs (including labour, materials, overheads and borrowing costs)(CU422,000).

30. Therefore, the staff recommends that the scope of the Exposure Draft is changed to include assets measured at fair value, with one exception—assets measured at fair value in accordance with IAS 41. Contrary to the approach taken in IAS 40, IAS 41 does not address accounting for subsequent expenditure under a fair value model. The IASC avoided the issue and stated in paragraph B62 of IAS 41: “the Board decided not to explicitly prescribe the accounting for subsequent expenditure related to biological assets in the Standard, because to do so is unnecessary with a fair value measurement approach.” The staff does not recommend extending the scope of IAS 23 to include assets measured at fair value in accordance with IAS 41. To do so, would impose change to the requirements of IAS 41 that, in the staff’s view, would require further consideration and re-exposure. If IAS 41 assets were to be included within the scope of IAS 23, an entity would be required to capitalise borrowing costs, whilst all other costs of a qualifying asset could either be expensed or

capitalised. The staff's view is that the issue of capitalising subsequent expenditure in IAS 41 should not be dealt with as part of the short-term convergence project on borrowing costs. Therefore, the staff recommends that the scope of IAS 23 excludes assets measured at fair value in accordance with IAS 41.

Include additional guidance on the capitalisation model

31. Some respondents asked for additional guidance on the capitalisation model in IAS 23, as follows:

    a. allocating borrowing costs to the various components of a single qualifying asset;

    b. allocating borrowing costs when land is the qualifying asset;

    c. intragroup financing, in particular, which borrowings need to be included in determining the weighted average capitalisation rate and whether an entity would have to capitalise if the subsidiary with the qualifying asset has borrowings but at the group level, a net liquidity position exists;

    d. the interaction between IAS 23 and IAS 39 with respect to derivatives on borrowings;

    e. applying adjustments to interest for foreign exchange differences;

    f. the effect of financial income arising on progress payments;

    g. the definition of a qualifying asset; and

    h. items to be included in investment income.

32. The staff does not recommend including additional guidance on the capitalisation model in IAS 23, for the following reasons:

    a. The staff discussed the issue with a number of preparers who capitalise borrowing costs in accordance with IAS 23. Those preparers have applied the requirements of IAS 23 without difficulty.

    b. The research, analysis and consideration of what guidance to include would take the project beyond the timelines set out in the MOU for short-term convergence.

c. The staff notes that most of the requests for detailed guidance in comment letters focus on issues that are common to any allocation of costs to an asset. Some are addressed in IAS 23 (like the interest earned on temporary investments). Others can be inferred from the guidance already in IAS 23. The staff sees no basis for providing detailed guidance about this particular cost allocation when practice has coped for years with other, very similar, problems.

Do nothing at present and discuss with the FASB and the SEC

33. Many respondents recommend that borrowing costs should be subject of a longer-term joint project with the FASB. Some suggest that it should be added as a separate joint project to the agendas of both boards, although views differ on the priority of such a project. Others view it as an integral part of the discussion on the initial measurement of assets within the Conceptual Frameworks project. Indeed, some might say that there is no need for a standard on borrowing costs if the basis for initial measurement is determined within the Conceptual Frameworks project.

34. The main arguments given by respondents for doing nothing at present and discussing with the FASB and the SEC the possibility of removing the item from the MOU are as follows:

   a. The negative response received from users. Users are united in their opposition of the proposals. Some would prefer to retain the two options of accounting treatment in IAS 23 until such time that assets would be measured at fair value on initial recognition. Some would support the capitalisation of an economic interest cost as an alternative (refer to paragraphs 35—37 for a discussion of an economic interest cost).

   b. The view that the costs of implementation would outweigh the benefits. Preparers expensing borrowing costs will incur costs in adopting a capitalisation policy.[5] Users will also incur costs in changing models for analysis. The proposals will improve

[5] Respondents suggest that the majority of first-time adopters expense borrowing costs given the difficulty of applying the principle of capitalisation retrospectively as required by IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

comparability by removing an accounting option and converging in principle with US GAAP. However, that improvement will not take effect until some time after the effective date of the amendments to IAS 23 as a result of prospective application. Given that the capitalisation of borrowing costs is a measurement issue and measurement is to be addressed as part of the Conceptual Frameworks project, the benefits might last only until publication of an amended Conceptual Framework. There is a question as to whether those benefits would outweigh the costs to be incurred by preparers and users of financial statements.

Capitalise an economic interest cost

35. Some members of the Analysts Representative Group suggest that the Board should propose the capitalisation of an economic interest cost. They support the view that financing is a cost that forms part of the economic cost of an asset. However, they do not support the capitalisation of borrowing costs because it is a partial capitalisation method, and the cost of an asset may be influenced by the capital structure of an entity. In their opinion, this could lead to accounting influencing an entity's decision about whether to build or buy, which "should never be the outcome of financial reporting standards" [quote from a user's comment letter].

36. In October 2005, the staff presented a paper to the Board that recommended the capitalisation of an economic interest cost. The staff proposed applying a current market risk-adjusted rate of return—that rate would reflect current market assessments of the time value of money and the risks specific to the asset, and would replace the existing rate derived only from borrowing costs incurred. The rate would be calculated in accordance with guidance in IAS 36 *Impairment of Assets*. The arguments put forward in support of that recommendation were as follows:

    a. The Board has decided that financing is a cost that forms part of the historical cost of an asset. The staff's view is that capitalisation of an economic interest cost achieves a faithful representation of the cost of an asset. It is a means of calculating and capitalising the *full* financing cost incurred in producing or constructing a qualifying asset.

b. The current market risk-adjusted rate of return would be consistent with the measurement of an asset's recoverable amount in IAS 36 and with the fair value measurement objective proposed in the Discussion Paper: Measurement Bases for Financial Accounting—Measurement on Initial Recognition.

c. This method would enhance comparability between the measurement of an asset built and an asset bought.

d. Capitalisation of an economic interest cost would avoid many of the problems identified with capitalising borrowing costs:

   i. The capital structure of an entity would not influence the cost of an asset.

   ii. As a result, the risk that entities might make decisions on whether to build or buy because of the accounting result is removed.

   iii. Additional guidance on the capitalisation model would not be required as requested by many respondents. Guidance is provided in IAS 36.

   iv. The method would enhance comparability over that achieved by capitalising only borrowing costs.

   v. An entity would expense all borrowing costs incurred, thus facilitating the calculation of ratios by credit analysts.

37. However, capitalisation of an economic interest cost would be an example of IFRS 'jumping ahead' of US GAAP. In addition, the project could not be achieved as part of short-term convergence. It would have to be considered as part of a longer-term project.

Remove the option of capitalising borrowing costs

38. Some respondents suggest that the Board should remove the option to capitalise borrowing costs. They argue that:

   a. the Board would remove an option in accounting treatment and therefore, improve comparability.

b. users have asked consistently for the presentation of an entity's business/operating results separate from the capital structure of the entity. Capitalising borrowing costs does not allow that distinction.

c. expensing borrowing costs means that the capital structure of an entity does not influence the cost of a qualifying asset, as is the case when borrowing costs are capitalised.

d. expensing borrowing costs is consistent with the approach on the financial statement presentation project, which proposes to present financing separate from business information in the financial statements.

39. However, the staff does not support this approach for the following reasons:

a. The Board decided that borrowing costs forms part of the historical cost of an asset and therefore, that capitalising borrowing costs is the best conceptual answer.

b. The suggestion is divergent from US GAAP.

c. Comparability decreases for two reasons:

i. The cost of a qualifying asset measured in accordance with IFRS will be different to an asset measured in accordance with US GAAP.

ii. The cost of an asset built would not include borrowing costs whilst the cost of an asset bought would include borrowing costs of the manufacturer (assuming that the manufacturer financed the production or construction of the asset).

d. An entity could abuse the requirements and capitalise borrowing costs whilst applying an accounting policy of expensing. This could be done by arranging that the manufacturer finances the costs of the asset and includes the financing cost in the purchase price.

Publish SFAS 34

40. Three respondents suggest that the Board should converge fully with US GAAP and effectively, publish SFAS 34. In that way, the Board would achieve full convergence on capitalisation of borrowing costs. Those entities that prepare

both IFRS and US GAAP financial statements would be required to maintain only one set of records in relation to capitalised borrowing costs.

41. However, the staff does not support this approach for the following reasons:

    a. The proposal would impose change on all entities that prepare IFRS financial statements, whether or not those entities previously captialised borrowing costs.

    b. SFAS 34, like IAS 23, is an old standard. Therefore, SFAS 34 is not necessarily of a higher quality than IAS 23.

Questions for the Board and Staff Recommendations

42. Question 1: Does the Board wish to proceed with the project as a short-term convergence project?

43. The staff recommends that the Board proceeds with the project for the reasons included in paragraph 21 of the paper.

44. **Question 2: If the answer to Question 1 is 'yes', does the Board agree with the staff recommendations that:**

    a. **IAS 23 should exclude inventories that are routinely manufactured, and**

    b. **IAS 23 should exclude assets that are measured at fair value in accordance with IAS 41?**