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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **January 2006, London**

Project: **Short Term Convergence: Borrowing Costs (Agenda Paper 4)**

Introduction

1. At the November Board meeting, the Board decided that in the short-term convergence project it would not address differences relating to borrowing costs other than the issue of capitalisation versus immediate expensing. Therefore the scope of the project is limited to the elimination of the option of immediate recognition as an expense of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. This paper addresses the transitional arrangements, first for existing IFRS users and then for first-time adopters.

Staff Recommendation

2. In the staff view, entities should generally apply the proposed changes in accounting policy prospectively, capitalising only those borrowing costs incurred after the effective date that meet the criteria for capitalisation.

3. However, entities should apply the proposed amendments retrospectively, to those qualifying assets that, at the effective date, are being under development to get them ready for their intended use or sale.

4. Additionally, an entity should be permitted to apply the proposed amendments to a qualifying asset developed after any date before the effective date, provided the information needed to apply the amendments was obtained at the time the qualifying asset was initially accounted for. In that case, the amendments should apply to all qualifying assets arising after such elected date.

   With regards to first-time adopters, the staff recommends that the transitional provisions for existing users should also apply to first-time adopters.

Staff Analysis

5. The development process of a qualifying asset may take a long period. Additionally some assets currently in use may have undergone and finished their production or construction process long years ago. If the entity has been following the accounting policy of immediate expensing, the costs to obtain the information required to capitalise retrospectively the borrowing costs and adjust the carrying amount of the asset may exceed the potential benefits. Hence, the staff recommends overall to apply the amendments prospectively.

6. However, a consistent policy over the development period should be adopted for assets whose development process is in progress. Allowing interest relating to such assets to be expensed would delay the application of mandatory capitalisation. The staff therefore recommends that retrospective application is required for assets whose development process is in progress, subject to it being practicable as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This approach also avoids incentives for entities to bring forward the beginning of the development process before the effective date.

7. The staff notes that the proposed amendments will result in more comparable information. On that basis, the staff concluded that if it were practicable for an entity to apply the proposed amendments from any date before the effective date, users of the entity's financial statements would receive more useful and

comparable information than previously. Therefore, entities should be permitted to apply the proposed amendments from any date before the effective date, provided the information needed to apply the amendments was obtained at the time the qualifying asset was initially accounted for. If an entity elects to apply the proposed amendments to any qualifying asset produced, constructed or acquired before the effective date, it shall apply the proposed amendments to all qualifying assets produced, constructed or acquired later. This would be consistent with the transitional provisions in IFRS 3 and IFRS 5.

8. Therefore, the staff is proposing the following effective date and transitional provisions: [Not reproduced in Observer Notes.]

9. The staff recommends that the proposed amendments should apply for financial periods beginning on or after 1 January 2008. This proposal will give entities sufficient time to prepare for the amendments, since in accordance with the project plan, the amendments are expected to be finalised and published in the second quarter 2007.

Alternatives

10. The staff has considered other alternatives. An option would be to require full retrospective application unless it is impracticable.

11. However, the staff does not consider this appropriate, for the reasons explained above in paragraph 5.

12. A third way would be to allow entities to apply the amendments prospectively, although they would be encouraged to apply them retrospectively.

13. The advantage of this alternative is that entities would have great flexibility in its application. However comparability and consistent application would be diminished. Hence this is not an option recommended by the staff.

14. A fourth alternative was considered. It is similar to the previous one with the difference that even if the entities elect to apply the proposed amendments prospectively, retrospective application would be required for qualifying assets under development.

15. The staff does not recommend this alternative for the same reasons as explained in paragraph 13. However the staff considers this alternative better than the third option.

First-time adoption of IFRSs

16. When IFRS 1 was enacted IAS 23 allowed the option of capitalising or immediately expensing borrowing costs. However, if a first-time adopter chose the IAS 23 allowed alternative treatment, the IFRS required retrospective application of that treatment, even for periods before the effective date of IAS 23.

17. IFRS's first-time adopters will face similar problems as entities that already use IFRSs as is explained in paragraph 6. If an entity has not previously gathered the necessary information for capitalisation of borrowing costs, getting it retrospectively may be costly.

18. First-time adopters do have the option of using fair value as the deemed cost of an asset at transition date, which would avoid the need for retrospective application. However, the use of an asset's fair value at the transition date as its deemed cost is not applicable to all qualifying assets, such as inventories. Further, the staff would argue that the existence of the deemed cost option is not enough to justify a tougher regime for the application of the proposed amendments for first-time adopters than for existing IFRS users. A tougher regime on the adoption of capitalisation could be justified when IFRS 1 was published because capitalisation was an option. The requirements for the application of *mandatory* capitalisation should be the same for existing users and first-time adopters.

19. Therefore, it would seem desirable to amend IFRS 1, allowing first-time adopters transitional provisions equivalent to those available to existing users under the [draft] amendments to IAS 23. Therefore, the staff proposes the following amendments to IFRS 1: [Not reproduced in Observer Notes.]