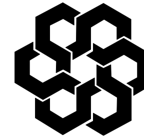

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

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: **17 November 2006, London**

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

Subject: **Comment letter analysis (Agenda Paper 6)**

Introduction

1. The Board published for comment an Exposure Draft of Proposed Amendments to IAS 23 *Borrowing Costs* in May 2006. The comment deadline was 29 September 2006 and the Board received 86 comment letters.

2. This paper presents an analysis of comments received relating to question 1 of the Exposure Draft and provides recommendations based on those comments. In summary, the paper discusses whether or not the Board should proceed with the publication of Final Amendments to IAS 23. The paper also includes the general views of respondents on question 2 of the Exposure Draft.

3. The staff plans to bring a paper to the Board in December 2006 addressing other issues raised by constituents in the comments letters.

Structure of the paper

4. The paper is structured as follows:

(a) Staff recommendations (paragraph 5)

(b) Analysis of respondents' comments agreeing with the Board's proposals (paragraphs 6 to 12)

(c) Analysis of respondents' comments disagreeing with the Board's proposals on the following grounds

   (i) Not short-term convergence (paragraph 14)

   (ii) What the Basis for Conclusions does and does not say (paragraphs 15 to 20)

   (iii) Problems with the method of calculation of amounts to be capitalised (paragraph 21)

   (iv) Consistency with other IASB projects (paragraph 22)

   (v) Effect on the presentation of financial information and benefit for users (paragraph 23)

(d) Suggestions made by respondents (paragraph 24)

(e) Question 2: The transitional provisions (paragraphs 25 to 26)

(f) The way forward – question for the Board and staff recommendation (paragraphs 27 to **Error! Reference source not found.**)

Staff Recommendations

5. The staff recommends that the Board publishes Final Amendments to IAS 23 that eliminate the option to immediately expense borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. The staff gives reasons for this recommendation in paragraph **Error! Reference source not found.** of this paper. The staff also recommends that the Basis for Conclusions more fully explains the Board's rationale for requiring the capitalisation model.

Staff Analysis

Question 1 in the Exposure Draft: The elimination of the option in IAS 23 of recognising immediately as an expense borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset

Agree with the Board's proposals

6. A minority of respondents agree with the proposal to eliminate the option to immediately expense borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. Some agree with the Board's conclusions in BC7-BC9 of the Exposure Draft that the acquisition cost of an asset should include the cost incurred in financing the expenditures. One respondent notes that "[borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset] are direct and incremental to the development of the asset and contribute to the future cash flow of the property…the capitalisation of these costs more accurately reflects the actual costs related to the development of the property."

7. Some support the proposal in the interests of removing an option in a standard and thus improving comparability. One respondent is "of the opinion that allowing optional contradictory treatments is intrinsically bad and so welcome the Board's proposals."

8. Some would have preferred a joint project with the US Financial Accounting Standards Board (FASB) to consider all of the differences between IAS 23 and SFAS 34 *Capitalization of Interest Cost*, but support the Board's decisions in the short-term. One respondent states that "since a joint project does not seem to be a realistic alternative at this stage, we support the Board's decision to eliminate the expense option but not to reconsider any of the other requirements of IAS 23."

9. Others refer to the importance of the Memorandum of Understanding (MOU) between the FASB and the IASB in working towards the elimination of the Securities and Exchange Commission's (SEC) requirement to reconcile IFRS and US GAAP. One respondent notes that it "would not wish [the IASB/FASB convergence MOU] to fail simply because the box could not be

ticked for this change to IAS 23". Despite having "conceptual reservations about capitalising interest expense as part of an historical cost asset measurement basis…[one respondent] recognises that the proposals in the ED are a key milestone in delivering the roadmap. We believe that the advantages of convergence for [the respondent] would outweigh the disadvantages of changing our accounting policy on this specific issue…we believe the Roadmap represents a real opportunity for achieving IFRS US GAAP convergence in the near future." Some respondents think that the Board should be more explicit in the Basis to say that a significant reason for proceeding with this proposal is the desire to eliminate the IFRS US GAAP reconciliation requirement.

10. Others recognise that whilst the proposals do not achieve convergence with US GAAP, it is a step towards convergence.

11. In addition, one respondent notes that before the adoption of IAS 23, the only permitted accounting treatment for such borrowing costs in Hong Kong was capitalisation. They argue that "based on our experience, we are not aware of any disadvantages of not having the option that the IASB proposes to eliminate."

12. Of those who agree, some have nonetheless raised concerns about the Board reaching its conclusions without a more comprehensive review of the strengths and weaknesses of immediate expensing versus capitalisation of borrowing costs. Their comments are mirrored by those of respondents disagreeing with the proposals and are noted later in this paper.

Disagree with the Board's proposals

13. A majority of respondents disagree with the proposals in the Exposure Draft. Their reasons are detailed in the following paragraphs.

Not short-term convergence

14. Many respondents are of the view that borrowing costs should be the subject of a joint project between the FASB and the IASB and, therefore, should not

be part of *short-term* convergence. Some of the arguments given are as follows:

(a) "Capitalisation of costs is a measurement issue, but we are unconvinced that capitalisation of interest on its own is of such significance that it should warrant the substantial time that would be necessary to produce a more thoroughly articulated proposal, in advance of looking at measurement bases as part of the conceptual framework activity."

(b) "We see the question of whether to capitalise interest to be a difficult conceptual issue, as the existence of allowed accounting alternatives in IAS 23 might indicate. Such alternatives suggest that there is a conceptual debate that has not been concluded. Indeed, FAS 34 was issued by the barest majority, suggesting that even in the United States the debate was not resolved satisfactorily. In addition, we find the application of the capitalisation approach to be a difficult issue in practice. For both these reasons, we are of the opinion that this issue deserves a proper debate and should not be the subject of a short-term project."

(c) "Longer term, we recommend a more comprehensive look at this topic. This should include an evaluation of capitalization in the context of assets carried at fair value, carrying costs of assets ready but not in use, the components of costs eligible for capitalization and whether they relate to all or only certain financial obligations, and to the extent that reflecting more fully the cost of assets built rather than bought is the objective of capitalization, whether the cost of equity financing should also be capitalized."

(d) Reasonable arguments can be advanced for either treatment and these need to be considered at more length in the context of the measurement of assets generally…the current options should remain until the case for changing IAS 23 can be justified on grounds of better financial reporting."

(e) "Although capitalisation of interest appears to be a minor issue, it has the potential to influence the outcome of a far wider question—what costs should be included in the initial measurement of an asset? As such the FRSB believes that it should be the subject of a more considered and detailed debate."

(f) "The strengths and weaknesses of the two approaches under consideration have not been analyzed in appropriate depth. We believe it is premature to decide which approach is more suitable for the users of financial statements."

(g) "We consider that short-term standard-setting projects are justifiable in areas in which there is a strong consensus as to the higher quality solution and where the cost impact is likely to be minor. In our view, neither condition applies in this case. The divergence of views expressed in the development of both IAS 23 and SFAS 34 *Capitalization of Interest Costs* regarding both the principle and the specific requirements, indicates that this is not an area where a major difference between IFRS and US GAAP should be eliminated in a short-term project...It seems that neither standard is considered to be of high quality and that both are in need of improvement. This is another reason why we do not therefore believe that this area can be addressed satisfactorily in a short-term convergence project."

(h) "Instead of a "quick fix", we believe strongly that standards such as IAS 23 and SFAS 34 should be overhauled and updated to incorporate more current thinking and Board deliberations."

What the Basis for Conclusions does and does not say

15. The Board gives four main arguments in the Basis for Conclusions to the Exposure Draft in support of its proposals:

(a) closer alignment and higher comparability with the required treatment under US GAAP (BC6);

(b) inclusion of borrowing costs in the initial measurement of an asset meets the definition of historical cost, as defined in the *Framework* (BC7-BC9);

(c) capitalisation of borrowing costs enhances comparability between assets that are internally developed and those acquired from third parties (BC10); and

(d) an expectation that capitalising borrowing costs will not impose an unduly burdensome cost on entities (BC10).

16. Respondents have challenged each of these arguments (refer to paragraphs 17 to 20 for comments from respondents). In addition, many are of the view that the Board has not made a sufficiently convincing case supporting a requirement to capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. Respondents argue the following:

(a) "We believe that legitimate arguments exist in support of either expensing or capitalizing borrowing costs, and accordingly, [we] do not advocate one of these alternatives as being preferable to the other. However, we believe it is important for the Board to elaborate in the Basis for Conclusions on its consideration of these alternatives, including its understanding of what users believe results in the best information in the financial statements….In light of the provisions of the Framework, we believe that the Board should select the treatment that results in the most useful information to investors or other financial statement users. Accordingly, we believe the Board should better explain in the final standard's Basis for Conclusions why, on balance, it selected capitalisation rather than expensing of borrowing costs. In particular, we are interested in how the Board considered and rejected arguments in favour of expensing. In addition, we encourage the Board to carefully consider the views of users in response to its proposal, to determine whether or not users believe capitalisation of borrowing costs is an improvement to financial reporting."

(b) "We agree that there are a number of arguments in favour of capitalisation of borrowing costs, however there are also a number of issues which have not been given due consideration in this exposure draft, such as whether it is appropriate to capitalise both general and specific borrowing costs. Furthermore, the basis for conclusions does not demonstrate any analysis of the strengths and weaknesses of the immediate expensing of borrowing costs, which is the preferred option in the existing standard. A fuller analysis of both options would be required to demonstrate that IFRS and US GAAP are converged around the better approach."

(c) "To develop clear conceptual support, we believe that the two Boards need to first examine the cost model for initial recognition. From that work the Boards should be in a position to explain whether the capitalisation approach proposed in the draft revisions to IAS 23 is more useful than expensing of

finance costs, and how that capitalisation model would be applied consistently to other costs that could be capitalised."

(d) "We feel that there needs to be tangible benefits associated with a policy of capitalisation beyond the convergence issue. At the very least it needs to be demonstrated that capitalisation is technically more superior and will result in a more relevant picture of an entity's performance and position. Unfortunately, we do not feel that the Basis of Conclusions adequately demonstrates that this will be the case."

(e) "We do not believe that a principle based analysis has been conducted in appropriate depth to support the elimination of an option in IAS 23. It is premature to decide which approach is more suitable for users without an analysis of comparative strengths and weaknesses."

(f) "The term "benchmark" was originally used to reflect the Board's intention of identifying a point of reference when making choices between alternatives…Obviously, the meantime the Board's point of reference has changed and expensing borrowing costs is no longer seen as the conceptually superior solution. It would be interesting to know what has caused this change."

Closer alignment and higher comparability with US GAAP

17. 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[1]. They think that convergence only on the principle of capitalisation, and not on the detail, 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). Some of their comments are as follows:

(a) "Any enhancement of comparability resulting from the proposed amendment could be compromised by differences in measurement."

---

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

(b) “Companies that wish to adopt the US practice of capitalising borrowing costs are already able to do so under existing IFRS. The proposals would therefore appear to be of little benefit to these companies, whereas they would require many thousands of companies for which US GAAP is of no relevance to change their accounting to a method that is more burdensome.”

(c) “A number of inconsistencies (most significantly composition of the costs under consideration and the calculation techniques) will continue to exist thus resulting in the amounts capitalised under IFRS and US GAAP being different. We therefore question the usefulness of the proposed change. That is particularly so bearing in mind that preparers already have an option of capitalisation and those wishing to achieve the amount of convergence with US GAAP that the proposed amendment achieves can simply follow this option.”

(d) “We are concerned that the proposals achieve only the appearance of convergence with US GAAP, without resolving the differences that will continue to exist…These differences could lead to materially different amounts being reported in financial statements—and they will need to be addressed subsequently as the convergence process moves forward.”

(e) “The amendment does not bring convergence but a mere alignment of accounting principle. Beyond this alignment in principle, specific and detailed IAS 23 requirements differ quite significantly from those of SFAS 34, in almost all aspects: definition of qualifying assets, computation method of interest costs. Therefore, entities listed in the US would have to carry up to three different sets of carrying amounts for their qualifying assets: at the subsidiary level in its separate financial statements (the financing structure between the subsidiary and the group may vary greatly), at the group level to comply with US GAAP, at the group level again to comply with IFRS.”

The definition of historical cost

18. A number of respondents disagree with the inclusion of borrowing costs in the historical cost of an asset. Their arguments include the following:

(a) “In our opinion, borrowing costs paid to lenders are not part of the consideration transferred for a qualifying asset, because they do not contribute to the asset’s functioning, its readiness for use, or to acquiring the

right to use it. Lenders are not usually parties to the transactions which create qualifying assets. Entities with net cash can acquire qualifying assets without incurring borrowing costs, and entities with borrowings may be able to finance asset acquisitions by issuing new shares. This suggests that incurring borrowing costs should be accounted for separately to asset acquisition."

(b) "It could be argued that the raising of capital and the application of capital are uncoupled, and therefore costs of financing should not influence the cost of the acquisition, construction or production or assets. In addition, it should be considered that financing activities generally contribute to the construction or production of assets only indirectly, if at all."

(c) "The fungible nature of cash makes it difficult to distinguish what funds are borrowed for what purpose—the capitalisation of interest would seem a sub-optimal outcome."

(d) "In cases where funds are not raised specifically to finance the acquisition of particular assets, we are not clear that it is meaningful to attribute a part of general borrowing costs to such purchases."

(e) "Weighted average capitalization rate on generally borrowed funds is an indicator that such borrowings are not directly attributable to the qualifying asset."

Comparability

19. Many respondents challenge the assertion made by the Board in the Basis that the proposals will enhance comparability between assets that are internally developed and those acquired from third parties. Some view an internally developed asset as an economically different transaction to a purchased asset and therefore, question the importance of comparability of such assets. Others highlight the lack of comparability of similar assets in situations where the financial structure of entities is different. Their arguments include the following:

(a) "We consider that there are key economic differences between the positions of an entity which constructs an asset by paying directly for all inputs and managing the project itself, and an entity which pays a third party to manage the construction and deliver a completed asset…Use of an indirect third party

structure would not normally give the entity the same result as if an entity capitalised cost directly—its own borrowing costs would usually be different from those recovered from it by a third party supplier."

(b) "Capitalising borrowing costs will result in a different historical cost basis for the same qualifying asset across entities (or within the same entity), depending on whether the qualifying asset's acquisition, construction or production was financed with debt, equity or a combination of both. We do not believe that the proposed capitalisation approach provides higher quality financial information than mandatory expensing….We disagree with [the assertion in BC10] because the selling price of an asset purchased from a third party generally would include a return of the seller's cost of capital (not only the cost of debt) as well as a profit margin."

(c) "Because it ignores the cost of equity financing, capitalisation of interest costs does not result in a meaningful indicator to analysts regarding the cost of assets built rather than bought."

(d) "With regard to comparability, the bank does not believe capitalising of interest achieves the objective. The main reason being the capital and financing base influences the cost of the asset and therefore the subsequent results. Therefore two businesses could acquire the same assets but as a result of one being financed by capital and the other by debt their results could be significantly different. It is also a common financial principal that financing should not be taken into account in deciding on an investment, the bank feels the capitalising of interest contradicts the principal."

(e) "It does not seem sensible to require an accounting treatment that potentially gives a favourable accounting result to an entity that borrows money (whether it needs to or not) compared to an entity that does not borrow… [eg] an entity who borrows money to acquire a qualifying asset, notwithstanding that it has sufficient existing surplus funds."

(f) "We believe that full comparability will not be achieved unless the full economic cost of funding is included in the cost of internally developed assets as it is in external prices, regardless of whether ten or a hundred percent has been financed by borrowings. Even then the credit rating of the third party (impacting the interest rates it is charged on its borrowings) and

the addition of a profit margin render the internal and external costs incomparable."

Cost of capitalisation of borrowing costs

20. Many respondents are not convinced that the costs of implementing an accounting policy of capitalisation will not be unduly burdensome. In addition, one preparer noted that the proposed changes to IAS 23 will create a a new IFRS/US GAAP difference that is expected to add a "huge administrative burden".[2] Comments of respondents include the following:

(a) "In its basis for conclusions, the IASB indicates that IAS 23 capitalisation method is not up to the quality standards sought by both the IASB and FASB. We therefore understand that the proposed amendment is rather short-term. Nonetheless capitalisation of borrowing costs demands a costly implementation exercise. We believe that it is against European interest to promote costly accounting changes which are not meant to last."

(b) "[One territory's] constituents did not consider that the benefits of capitalising borrowing costs justified the expense. This is especially the case where central financing operations make it difficult to attribute borrowing costs to specific assets."

(c) "The amendment creates an administrative burden with no added value for the users, and hits all IFRS compliant entities in Europe although the change is aimed at benefiting only a small number of them."

(d) "We do not agree with the Board's expectation that capitalising borrowing costs will not impose an unduly burdensome cost on entities. Prior to the adoption of [the current Korean accounting standard similar to IAS 23], Korean entities has been required to capitalise borrowing costs directly attributable to the acquisition, construction or production of an asset. Based on our experience of that period, we observed certain cases where Korean

---

[2] Because of the scope exclusion in SFAS 34 for inventories that are routinely manufactured, Diageo (CL84) do not capitalise borrowing costs on inventories of whisky and wine in accordance with SFAS 34. The staff will discuss inventories that are routinely manufactured in its December 2006 Board paper. [Sentence omitted from observer notes.]

entities had incurred unduly [burdensome] costs to comply with the requirement of capitalising borrowing costs. Specifically, the deferred effect on the financial statements through the capitalisation of borrowing costs had been relatively immaterial although much effort had been needed to calculate the amount of borrowing costs to be capitalised, especially in regards with weighted average borrowing costs related to funds borrowed generally."

(e) "I am not convinced that the extra costs incurred to analyse interest costs on all projects that extend over a substantial period are justified by the loss of comparability to cash profits…particularly if the standard will need further amendments to achieve convergence with a revised US GAAP approach at a later stage."

(f) "We consider that the requirement to use a consolidated view to capitalise borrowing costs adds a significant complication to the mechanics of the consolidation as this leads to the need to "push-down" to the reporting units yet another entry which will usually lead to additional deferred tax temporary differences."

(g) "The Board proposes to move closer to US GAAP without any real debate as to whether that will result in better accounting as well as that the IASB concluded not to spend "time and resources considering aspects of IAS 23 beyond the choice between capitalisation and immediate recognition as an expense" (refer to BC3), we believe that companies that prepare and issue IFRS—US GAAP reconciliation should also have the benefit of not spending more time and resources on this issue than necessary."

Problems with the method of calculation of amounts to be capitalised

21. A number of respondents 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 are in need of updating. Their arguments include the following:

(a) "[One respondent] is concerned that the proposal significantly increases the ability to manipulate profit or loss particularly in entities where capital expenditure is decentralised and financing operations are centralised (the norm)…If finance costs were to be included [in the cost of an asset], it would only be appropriate to use a real rate rather than a nominal rate, so that

expectations about holding gains/losses incorporated in the nominal rate do not lead to double counting."

(b) "The capitalisation of borrowing costs risks creating inflated asset values that can only be corrected via impairment charges…The application in groups may be complicated by the different rates of interest attaching to borrowings from group companies (which might apply to the individual accounts of subsidiaries) as compared to the interest on group borrowings from third parties applicable to the consolidated accounts."

(c) "An entity's borrowings are likely to comprise debt of varying maturities and currencies and, therefore, carrying different, perhaps substantially different, effective interest rates. As a result, the capitalisation applied to a specific asset may bear little or no relationship to the maturity of the currency of the borrowings required to finance its acquisition, production or construction."

(d) "The bank believes in high interest rate environments it may not be appropriate to capitalise the interest because the asset could potentially be overstated."

Consistency with other IASB projects

22. Some respondents are of the view that the proposal to require capitalisation of borrowing costs is not consistent with the direction that the Board has taken in other projects. In particular, respondents referred to the Business Combinations II project and the Financial Statement Presentation project, and also to the requirements of IAS 16. Their comments include the following:

(a) "The existing IAS 23 capitalisation requires the imputation of a borrowing cost in cases when assets are financed from general borrowings…This approach to the determination of cost seems inconsistent with other IFRS requirements. For example, only directly attributable costs (and therefore not general overhead costs) are elements of the cost of an asset in accordance with IAS 16."

(b) "Constituent also argued that capitalisation of interest cost contradicts the approach currently discussed under the IASB's Financial Statement Presentation Project which aims at separating an entity's financing activities from its business and other activities."

(c) "Fitch is supportive of the intention of the IASB and FASB to bring more cohesiveness (or "linkage") between the various primary financial statements. We question whether more capitalisation of borrowing costs will assist in linking the income statement to the cash flow statement…We think the principle of capitalising certain borrowing costs contradicts the principle of expensing acquisition costs proposed in the IASB's Exposure Draft of Proposed Amendments to IFRS 3 Business Combinations…We have difficulty reconciling the principle of capitalising borrowing costs under US GAAP with the principle of applying "exit value" to fair value measurement."

(d) "I believe that borrowing costs to bring a fixed asset into use or inventory to a point where it is ready for sale, are intellectually similar in nature to acquisition costs incurred to bring a new entity into the group. Both economic costs are necessary to deliver the outcome."

(e) "We note that the upcoming exposure draft on SME's requires borrowing costs expensed as incurred. Although we acknowledge that the purpose of the SME project may be to give SMEs relief from burdensome requirements that fail the cost-benefit test it may cause confusion if different measurements are proposed at the same time without clear conceptual support for one of them."

(f) "It is not immediately apparent to us why such costs [all incidental costs incurred on a business combination] are less deserving of capitalisation than borrowing costs incurred on acquiring a qualifying asset."

(g) "In the course of the current project "Presentation of Financial Statements" the IASB and the FASB are discussing what constitutes financing and where the effects of financing should be shown in the income statement. The treatment of borrowing costs and their presentation should be solved in this context rather than proposing a quick fix."

Effect on the presentation of financial information and benefit for users

23. Finally, 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. Indeed, all of the four users / user groups who responded

to the Exposure Draft disagree with the proposals. Respondents' arguments include the following:

(a) "We believe that the need to align IFRS and US GAAP standards on borrowing costs is not pressing, and any required capitalisation of borrowing costs only adds to the magnitude of adjustments to interest expense made by our analysts. Our established criteria for the calculation of ratios of non-financial companies, to which this topic most applies, call for the reversal of capitalised interest. The adjustment reveals the full amount of interest cost in a period and facilitates analysis of operating/investing outcomes separate from that of financing, so that these elements can be evaluated independently, insofar as they relate to our assessment of the business and financial risk profile of a company…Because it ignores the cost of equity financing, capitalisation of interest costs does not result in a meaningful indicator to analysts regarding the cost of assets built rather than bought…we question the utility of a partial capitalisation model to financial statements' users and the need to amend IAS 23 at this point…Credit analysis focuses on an entity's ability to repay and service its obligations. A key component of our analysis is a review of coverage ratios in respect of total interest cost for a company (that is, interest expense which would be paid or payable to a lender in a given period, before any capitalisation). As our focus is on total interest, we reverse capitalised interest for the calculation of ratios that use interest expense, such as interest cover ratios"

(b) "We think it is important to point out that [requiring certain borrowing costs to be capitalised] does not assist our analysis…Identifying borrowing costs, generally on a cash basis, and a company's ability to service these out of operating cash flows is a core part of our analysis. It would be very unusual for us to assess interest costs net of those capitalised. We view borrowing costs as an expense and a financing cash outflow."

(c) "We do look at operating items on the balance sheet quite differently to financial items as we do not generally consider the former on a "fair value" basis in contrast to financial items such as pensions, provisions, financial instruments and debt."

(d) "Capitalisation of borrowing costs results in unnecessary complexity in financial reporting, ie, the creation of differences between reported earnings

and cash flows depending on the financial structure of the firm…Candidates preparing for the CFA exam are instructed to make the following adjustments as part of their analysis of a firm's financial statements: *Capitalised interest should be added back to interest expense*. The adjusted interest expense provides a better presentation of the level and trend of a firm's financing costs…*The capitalisation of interest also distorts the classification of cash flows. Interest capitalised as part of the cost of fixed assets will never be reported as CFO (Cash from Operations), but as an investment outflow...The interest coverage ratio should be calculated with interest expense adjusted to add back capitalised interest*."

(e) "The costs of financing the business should be considered separately from the costs of the business itself (cf. the present discussion on presentation of financial statement)…The capitalisation of certain interest costs substantially increases accounting complexity and reduces the transparency of the financial statements, as users must make adjustments to the published figures to arrive at cash flow amounts under the headings that they can use for forecasting future cash flows. Similarly, analysis of the entity's cost of capital would be made considerably more difficult…we understand that credit rating agencies "de-capitalise" the capitalised interest of US firms when doing their analysis, which suggests that some key users would prefer expensing as the single permitted method."

(f) "The additional effort could only be justified, in our view, if the proposed amendment increased the transparency of financial reporting. However, the capitalisation of borrowing costs is an essentially theoretical adjustment that does not provide meaningful information to a user of the accounts on either the cost of the asset based or the debt structure of a company."

(g) Regarding the capitalisation of borrowing costs relating to inventories that are routinely manufactured, "in times of reducing interest rates to explain why cost of sales are increasing because of high interest rates a number of years ago would be extremely confusing and not particularly informative."

Suggestions made by respondents

24. Respondents disagreeing with the Board's proposals to require capitalisation of borrowing costs make the following suggestions for the way forward:

(a) Many recommend that borrowing costs should be subject of a longer-term joint project with the FASB, perhaps conducted in conjunction with the discussion of the measurement of assets in the Conceptual Frameworks project. There are differing views on the priority that should be given to such a joint project, but general agreement that borrowing costs should not be dealt with as part of short-term convergence (refer to paragraph 14 of this paper for comments received from respondents).

(b) Others suggest the elimination of the option to capitalise borrowing costs if the objective of the project was to eliminate one of the two options of accounting treatment available. One respondent expresses the view that "the costs of financing the business should be considered separately from the costs of the business itself…if one IAS 23 option has to be eliminated, it should be that of capitalising." Another respondent states that "if the purpose of the Exposure Draft is to eliminate having an option of how to treat borrowing costs relating to certain assets and also to converge with US GAAP, a workable alternative that would be helpful to users, as least on the credit side, would be to eliminate the possibility of capitalising borrowing costs in all IFRS and US GAAP standards."

(c) Three respondents suggest replacing IAS 23 with SFAS 34. They view the advantages of full convergence as outweighing any costs of implementing a different capitalisation method. One respondent suggests that "if the Board remains intent on mandating the capitalisation of borrowing costs on qualifying assets it simply replaces IAS 23 with SFAS 34."

(d) Others suggest that the Board should include additional guidance on the following:

    (i) the allocation of borrowing costs to the various components of a single qualifying asset;

(ii) 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;

(iii) the interaction between IAS 23 and IAS 39 with respect to derivatives relating to borrowings;

(iv) the application of adjustments to interest for foreign exchange differences;

(v) the interaction between IAS 23 and IAS 40;

(vi) the effect of financial income arising on payments made on account by customers;

(vii) the definition of a qualifying asset; and

(viii) items to be included in investment income.

Question 2 in the Exposure Draft: The transitional provisions

25. The vast majority of respondents agree with the transitional provisions in the Exposure Draft, noting that they are pragmatic and appropriate given the nature of the amendments proposed to IAS 23.

26. Other comments related to question 2 will be discussed at the December Board meeting.

The way forward – question for the Board

27. In the staff's view, the Board has only two options in addressing borrowing costs as part of short-term convergence:

(a) View A: publish the amendments to IAS 23 largely as exposed. Thus, the Board would eliminate the option to immediately expense borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

(b) View B: do nothing at present, and discuss with the FASB and the SEC the possibility of removing the project from the roadmap to eliminate the IFRS US GAAP reconciliation requirement.

Any other action would extend the timing of the project beyond the timelines set out in the MOU for short-term convergence projects.

28. The arguments in favour of View A are as follows:

(a) The capitalisation of borrowing costs directly related to the acquisition, construction or production of a qualifying asset meets the definition of historical cost as defined in the *Framework* as noted in BC7-BC9 of the Exposure Draft. When an asset takes a substantial period of time to get ready for its intended use or sale, the expenditure for materials, labour and overheads must be financed. That financing has a cost, which forms part of the cost of bringing the asset to its location and condition for use or sale. The return generated on the qualifying asset through use or sale should provide a return on such financing costs as well as materials, labour and overheads included in the cost of the asset.

(b) The amount recognised as the cost of an asset should be the same regardless of whether the entity constructs the asset itself of whether the entity buys the completed asset from a contractor. Immediate expensing of borrowing costs does not achieve that comparability. Capitalisation of borrowing costs achieves it for assets that are financed by borrowing, albeit it not for assets financed by equity.

(c) An option in IFRS literature would be removed and thus, comparability across entities would increase. As noted by [a respondent], it is "intrinsically bad" to allow optional contradictory accounting treatments. At present, an entity could capitalise an amount for borrowing costs of zero (if an entity chooses to immediately expense) or a number calculated in accordance with paragraph 11 of IAS 23. Comparability will improve if the possibility of capitalising zero is removed. Further, the option allows entities to manage profit

by structuring its methods of payment. An entity can present itself as a 'prudent' immediate expenser of borrowing costs whilst, in effect, capitalising such costs by entering into a 'turnkey' contract under which it pays the costs of construction, including borrowing costs, to a sub-contracter as the price for the asset.

(d) IFRS and US GAAP literature regarding borrowing costs would be converged in principle, although the amount of borrowing costs capitalised in accordance with IFRS and US GAAP could be different (because of the differences that would remain between IAS 23 and SFAS 34 as noted in paragraph 17)[3].

(d) The Board would achieve one of the goals of the MOU between the FASB and the IASB. As noted by [a respondent], "we believe that the advantages of convergence would outweigh the disadvantages of changing our accounting policy on this specific issue…we believe the Roadmap represents a real opportunity for achieving IFRS US GAAP convergence in the near future."

29. The arguments in favour of View B are as follows:

(a) All users and user groups (as well as many preparers, standard setters and other constituents) responding to the Exposure Draft are not convinced that the principle of capitalising borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset produces information in financial statements "that is useful to a wide range of users in making economic decisions."[4]

i. Credit analysts reverse any capitalised borrowing costs in performing their analysis of financial statements—they are

---

[3] A problem may arise for entities that have inventories that are routinely manufactured and take a substantial period of time to get ready for sale (eg whisky or wine producers). Such entities would be required to capitalise borrowing costs in accordance with the amended IAS 23, whilst being required to expense borrowing costs in accordance with SFAS 34. As noted in the footnote to paragraph 20, this issue will be brought to the December Board meeting.

[4] Extract from paragraph 12 of the *Framework*—The objective of financial statements

interested in identifying total interest cost for a period and in analysing operating/investing outcomes separately from that of financing.

ii. The removal of an option in IFRS literature that converges in principle with US GAAP would improve comparability. However, given that the amounts capitalised would still not be *fully* comparable[5], there are doubts as to the benefits to be obtained from a capitalisation requirement as detailed in IAS 23. As noted by [a respondent], "because it ignores the cost of equity financing, capitalisation of interest costs does not result in a meaningful indicator to analysts regarding the cost of assets built rather than bought. Further, other costs are not mandated to be capitalised under existing IFRS and US GAAP. Therefore, we question the utility of a partial capitalisation model to financial statements' users and the need to amend IAS 23 at this point."

In addition, users would not obtain the benefits from increased comparability for some time after the effective date because the amendments to IAS 23 would be applied prospectively.

(b) As noted above by respondents, the capitalisation of borrowing costs is, in effect, a partial capitalisation method. Cash used to fund the expenditure of a qualifying asset can be obtained from a variety of sources—operating activities, borrowings, issue of equity securities—only one of those sources (borrowings) gives rise to a cost that is recognised in financial reporting and thus, is capitalised as part of the

---

[5] The proposed amendments to IAS 23 would not achieve full comparability for three reasons: 1. entities that finance the expenditure on a qualifying asset using cash or equity, rather than debt, would effectively capitalise zero in relation to the costs of financing. 2. many differences remain in the detail of how and what to capitalise in IAS 23 and SFAS 34 literature and therefore, it is likely that different amounts would be capitalised when complying with both standards. 3. the cost of an asset that is built will not be the same as the cost of an asset purchased because a purchased asset would include the costs of equity as well as debt financing, and also include a profit margin on all expenditures.

cost of a qualifying asset. As a result, the cost of an asset may be different solely because of differing capital structures of reporting entities.

(c) Paragraph 14 of IAS 23 states that "the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required". This would imply additional costs for those preparers that immediately expense all borrowing costs.[6] Users also note that they will incur costs in either changing their models for analysis or obtaining information on total interest costs (and operating costs excluding the amortisation of previously capitalised interest costs) for a period from a different source than the financial statements. There is a question as to whether the benefits of the proposed amendments would outweigh the costs to be incurred by both preparers and users of financial statements.

(d) Entities (particularly those that are in a net liquid position either at subsidiary or group level) may be in a position to manipulate the amount of borrowing costs capitalised and indeed, whether or not borrowing costs are capitalised. For example, an entity that is in a net liquid position could borrow funds (even if those funds are not required) and argue that these are directly attributable to the acquisition, construction or production of a qualifying asset. It would recognise investment income as incurred whilst recognising borrowing costs in later periods when the qualifying asset is in use or sold. Equally, when the financing activity of an entity is coordinated centrally (which is usually the case) and the entity has a range of debt instruments with varying rates of interest, that entity may be able to justify several different capitalisation rates and therefore, choose the one that produces results that best suits its desired outcome at that time.

---

[6] Respondents have noted that the majority of first-time adopters use the option to immediately expense borrowing costs given the difficulty of retrospectively applying the principle of capitalisation as required by IFRS1 *First-time Adoption of International Financial Reporting Standards*.

Staff Recommendation

30. The staff supports view A. The staff's view is that immediate expensing of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset does not give a faithful representation of the cost of the asset. Ideally, the staff argues that a faithful representation of cost would be achieved by capitalising an economic interest cost[7]. However that is not a possibility in a short-term convergence project. The staff continues to regard capitalisation of borrowing costs as a better alternative to immediately expensing those costs. The staff does not agree with those respondents that argue that self-developed assets and acquired assets are fundamentally different. The staff thinks that the cost of assets should be the same, regardless of how the entity acquires them. The staff acknowledges that capitalisation of borrowing costs does not achieve comparability between liability financed and equity financed assets. However, it achieves comparability between 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.

31. The staff is not persuaded either that the cost of capitalising borrowing costs is excessive or that IAS 23 is particularly open to manipulation of the amounts to be capitalised. IAS 23 does state that the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required. However, it goes on to tell entities how to determine the amount to be capitalised, analysing the issue into two categories: (i) when funds are specifically borrowed for the purpose of obtaining the qualifying asset and (ii) when funds are borrowed generally and used for the purpose of obtaining a qualifying asset. There may

[7] As recommended by the staff in Agenda Paper 12 for the October 2005 Board meeting. The economic costs directly attributable to the acquisition, construction or production of a qualifying asset would be calculated by applying a current market risk-adjusted rate of return to the expenditures on the asset. That rate would reflect current market assessments of the time value of money and the risks specific to the asset.

be specific issues of difficulty, which the staff will analyse for the December meeting but the staff is not aware of pervasive problems.

32. Removal of the option in IAS 23 also simplifies IFRSs and achieves a goal in the MOU.

33. The staff also recommends that the Basis for Conclusions to the Final Amendments includes a more detailed discussion of why the Board opted for the capitalisation model.