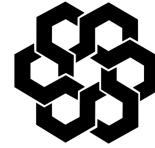

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International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2007, London**

Project: **Borrowing costs (Agenda Paper 7C)**

INTRODUCTION

1. In August 2007, the IFRIC received a request for it to issue guidance on the accounting for foreign exchange differences associated with capitalised borrowing costs. IAS 23 *Borrowing Costs*[1] states:

   'Borrowing costs may include…exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.'

2. Such foreign exchange differences may result in gains or losses for an entity. In some periods, foreign exchange gains, including those on the principal amount borrowed, may exceed the interest charge.

3. The request asked for guidance on two questions. Firstly, to what extent should foreign exchange differences be regarded as an adjustment to interest costs? Secondly, when an entity hedges its exposure to foreign exchange movements,

[1] Note: throughout this document paragraph references are to the revised IAS 23 issued in March 2007 and not the version of IAS 23 included in the Bound volume as at 1 January 2007.

to what extent should costs associated with the hedging instrument be considered to be part of the borrowing costs that may be capitalised?

4. The staff notes that the questions consider a range of different scenarios. These can be divided between those in which a hedging instrument is used to hedge the foreign exchange risk and those in which no hedging takes place.

DIFFERING VIEWS

5. The submission noted a number of different approaches that it stated were used to determine which exchange differences are an adjustment to interest costs. The staff notes that a number of other methods may exist. Additionally, the methods identified in the submission may be applied in different ways. At this stage, the staff has not attempted to identify all possible approaches that could be used.

6. The approaches identified in the submission could be divided into two categories. The first treats all foreign exchange gains and losses as an adjustment to interest until the net cost equals zero. In other words, all foreign exchange gains and losses are included in borrowing costs so long as there is a net cost. A net gain cannot be capitalised. This approach results in all foreign exchange losses being capitalised but foreign exchange gains above a limit being recognised in profit or loss.

7. The second approach attempts to identify the part of the foreign exchange movement that relates to the interest rate differential between the entity's functional currency and the currency of the foreign borrowing. This portion of the foreign exchange movement may be estimated based on:

- interest rates on similar borrowings in the entity's functional currency; or
- forward rates at the inception of the loan.

8. IAS 23.9 states that an entity shall capitalise borrowing costs that are directly attributable to the acquisition, production or construction of a qualifying asset. In situations in which an entity hedges the foreign exchange exposure, a further question arises as to whether the costs associated with the hedging instrument are directly attributable. At this stage, the staff has not attempted to identify approaches to determine whether costs are directly attributable other than those

mentioned in the submission. The submission identifies three different approaches that could be applied :

- Only derivatives that meet the hedge accounting criteria in IAS 39 *Financial Instruments: Recognition and Measurement* may be included as directly attributable for the purpose of IAS 23.
- Whether the derivative meets the hedge accounting criteria in IAS 39 is irrelevant. If it can be demonstrated that the derivative is directly attributable (ie the costs would have been avoided if expenditure on the qualifying asset had not been made), the net cash costs of the hedging instrument for the period are included in the costs eligible for capitalisation for the purpose of IAS 23.
- Whether the derivative meets the hedge accounting criteria in IAS 39 is irrelevant. If it can be demonstrated that the derivative is directly attributable (ie the costs would have been avoided if expenditure on the qualifying asset had not been made) the amounts taken to the income statement for the period (ie the change in fair value) are included in the costs eligible for capitalisation for the purpose of IAS 23.

9. The submission to the IFRIC states:

"We have reviewed the financial statements of a range of companies, and noted that the disclosures, including the accounting policy, were not sufficiently detailed to identify differences in approaches. However the published guidance by each of the large firms shows considerable diversity in how this is interpreted"

10. This diversity is also evident in the publications of some of the large accounting firms. For example, published guidance of one of the large firms states:

"There is no further guidance on the conditions under which foreign exchange differences may be capitalised and in practice there are different views about what is acceptable."

11. The staff considers that the fact that more than one of the large accounting firms have indicated that there is diversity in this area provides prima facie evidence that diversity exists.

STAFF ANALYSIS

Foreign borrowing with no hedging of the foreign exchange exposure

12. The staff first considered a situation in which an entity enters into a foreign currency borrowing to finance an asset that is not denominated in that currency. The entity does not hedge the foreign exchange risk associated with that borrowing.

13. IAS 23.6 states that borrowing costs may include foreign exchange movements '*to the extent* that they are regarded as an adjustment to interest costs' (emphasis added). From this statement, the staff concludes that not all foreign exchange gains and losses may be included in borrowing costs to be capitalised. In other words, some foreign exchange gains and losses are an adjustment to interest costs and some are not.

14. The gains and losses that are an adjustment to interest costs will include the interest rate differential between the entity's functional currency and its foreign borrowings. Other differences that are not adjustments to interest costs may include, for example, increases or decreases in the foreign currency rates as a result of changes in other economic indicators such as employment or productivity, or a change in government.

15. In the staff's view, IAS 23 is clear in requiring that only the differences regarded as adjustments to interest costs should be part of borrowing costs. However, the staff notes that there is no guidance in IAS 23 as to how an entity should identify which differences should be regarded as adjustments to interest costs or how they should be determined.

16. In conclusion, whilst IAS 23 requires a split to be made, it is not prescriptive as to which method should be used to estimate the amount of foreign exchange that may be included in borrowing costs.

17. In the light of this, the staff does not believe that there is anything in IAS 23 that would rule out:

    - using a method based upon forward rates at the inception of the loan; or
    - using the rates on similar borrowings in the entity's functional currency

to compute the portion of the foreign exchange movement that should be considered an adjustment to borrowing costs.

18. Consequently, determining the amount that is an adjustment to borrowing costs is an accounting policy choice and entities should take into account the guidance on selecting an appropriate accounting policy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. In particular, IAS 8 requires an entity to select the accounting policy that results in information that is relevant and reliable. It also requires that the policy be applied consistently to similar transactions (ie the same policy should be applied to all borrowings for qualifying assets) and to foreign exchange differences whether they are gains or losses. The staff also notes that a consistent approach should be used from one period to the next unless the conditions for a change in accounting policy set out in IAS 8.14 are met.

Treatment of a hedging instrument

19. The staff next considered situations in which the borrowing entity hedges changes in foreign exchange rates. The submission asked for guidance as to whether the costs associated with the hedging instrument should be considered to be a part of borrowing costs.

20. In order to determine whether such costs may be eligible for capitalisation in accordance with IAS 23, it is first necessary to assess whether they are 'directly attributable to the acquisition, construction or production of a qualifying asset.'

21. IAS 23.11 discusses the issue of how to determine whether costs are directly attributable. This states:

    'It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided...As a result, 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.'

22. In writing the standard, the Board did not develop guidance to define the types of costs that may be included in the borrowing costs eligible for capitalisation. When amending the standard the Board again had the opportunity to introduce a test, for example that 'only costs associated with instruments that met the hedge

accounting criteria in IAS 39 may be included in borrowing costs' but decided not to.

23. The staff considers that, in the case of a hedging instrument, judgement will be required. For example, an entity may decide to hedge its foreign exchange exposure because a bank makes it a condition of lending to the entity. In this case, the entity may conclude that the cost of the hedging instrument is directly attributable to the acquisition, construction or production of the asset.

24. In contrast, an entity may have a 3 year fixed rate loan in a foreign currency. Political turbulence in the foreign country may lead the entity to decide that it is at increased risk from foreign exchange fluctuations and so it may hedge its exposure. In this case, it may conclude that the cost of the hedging instrument is attributable to the political risk and is not an adjustment to interest rates.

25. In using judgement to assess whether costs associated with a hedging instrument should be capitalised, the staff considers that entities will need to take into account all relevant facts and circumstances on an instrument by instrument basis. For example, entities may wish to consider what risks are being hedged and how those underlying risks are reflected in the financial statements. Entities may also wish to consider the reason for entering into the hedging instrument. The determination may be influenced by whether the hedge qualifies for hedge accounting under IAS 39 and, if so, whether the hedge is effective. Entities may decide that a portion of the costs associated with a hedging instrument are a part of borrowing costs and that other portions are not.

26. The staff therefore concludes that, in writing IAS 23, the Board intended that an entity should use judgement in assessing which costs should be considered to be directly attributable to the borrowing. It is not possible to dictate that a class of items such as hedging instruments is or isn't directly attributable.

Conclusions

27. The staff concludes that, in situations in which foreign exchange risks are not hedged, foreign exchange movements must be split between those that are regarded as an adjustment to the interest cost and those that are not. IAS 23 is not prescriptive in requiring any particular method, and there is nothing in the standard that precludes the use of forward rates or of functional currency borrowing rates as a benchmark.

28. The staff concludes that, in situations in which there is a hedge of the foreign exchange risk associated with overseas borrowings, some of the costs associated with the hedging instrument may be regarded as being directly attributable to the borrowing depending on the facts and circumstances.

29. However, the staff does not consider that the guidance in IAS 23 is prescriptive in requiring the costs of specific instruments to be included in or excluded from borrowing costs. Instead, this is a matter for judgement based upon whether such costs are directly attributable as described in IAS 23.

SHOULD THE ISSUE BE TAKEN ONTO THE IFRIC AGENDA?

30. The staff considered whether the issue should be taken onto the IFRIC agenda with reference to the agenda criteria set out in the IFRIC Due Process Handbook.

Widespread and practical relevance

31. The staff notes that, following the amendments to IAS 23 that require the capitalisation of interest, the issue is now of wider relevance as it affects all companies that develop qualifying assets financed by debt.

32. The submission also argues that, in the past, practice had developed such that foreign exchange losses that may be capitalised were generally capped based on local currency lending rates. However, foreign exchange movements in recent years have meant that more entities are recognising foreign exchange gains on their foreign borrowings and that, in some cases, this is resulting in gains that exceed the interest cost.

33. The staff therefore concludes that the issue has widespread relevance.

34. Furthermore, the calculation of the amount of borrowing costs that should be capitalised is a practical issue.

35. The issue could therefore be considered to be of widespread and practical relevance.

36. However, the staff also considers that the issue could be seen as asking for application guidance. The principle to be applied is that PPE is recorded on initial recognition at cost. The cost to be recorded is the cost of bringing the asset to the location and condition to be capable of being used as intended by

management. IAS 23 establishes that that cost includes the cost of borrowing that is used to finance the construction or development of the asset, and that the cost of borrowing includes those foreign exchange gains and losses that are regarded as an adjustment to interest costs.

37. Developing further guidance as to how an entity establishes which foreign currency gains and losses are regarded as adjustments to interest costs and which are not would be developing application guidance as to how entities should perform the calculations required to apply the principle in IAS 23.

Significantly divergent interpretations

38. The staff notes that both the submission and the content of the firms' guidance imply that there is divergence in practice in this area. This divergent practice may lead to significantly different amounts of borrowing costs being capitalised and significantly different amounts being recognised in income.

39. For example, if the foreign exchange gain exceeds the interest charge, under one method nil may be capitalised with a net gain recognised in income. Other methods may result in a variety of amounts being capitalised based on local currency borrowing rates or forward rates at the time that the loans were entered into.

40. However, the staff notes that capitalised borrowing costs are only part of the cost of an asset. When entities are largely financed by equity (rather than debt) total borrowing costs may be relatively small. Even if financed entirely by debt, the proportion of the cost of an asset that comprises borrowing costs may be relatively low. For example, an asset costing CU1m that is built evenly over 6 months financed by debt with an interest rate of 5% will capitalise interest of CU12,500[2] (or 1.25% of its cost). Similarly, in a mature business, the amount of interest capitalised may be largely matched in profit or loss by increased depreciation on capitalised interest included in the cost of assets.

41. The staff therefore considers that, in many cases, the amount of interest capitalised may not be material to either the cost of assets or profit or loss. Similarly the amount of the foreign exchange gains or losses that is an adjustment to interest costs may be immaterial in many cases.

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[2] Based upon an average amount of capital work in progress of CU500,000 multiplied by an interest rate of 5% pa divided by 2 to reflect the fact that construction is completed in half a year.

42. It may therefore be argued that, whilst divergent methodologies exist, the difference between the different approaches is unlikely to be significant in most cases.

43. The previous version of IAS 23 required that entities disclose the accounting policy adopted for borrowing costs to distinguish between entities that capitalised interest and those that did not.

44. The staff notes that theis may partly explain the lack of detailed disclosure about entities' accounting policies for foreign exchange movements included in borrowing costs. Entities may have historically considered that borrowing costs are sufficiently significant to require the disclosure of the accounting policy choice as required by IAS 23 but that the foreign exchange element is not sufficiently material to require separate accounting policy disclosure.

Improvement to financial reporting

45. The staff considers that removing the diversity in this area would result in increased comparability amongst preparers and increased transparency in the way that the financial statements are prepared.

46. It could therefore be argued that reducing the diversity in this area would lead to an improvement in financial reporting.

47. The staff notes however that IAS 23.26 requires disclosure of:

    (a) the amount of borrowing costs capitalised during the period; and

    (b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

48. Furthermore, the staff believes that IAS 1.108 requires disclosure of the policy for capitalising borrowing costs if it is material, including the policy for capitalising foreign exchange gains and losses and the effect of associated hedging activities. IAS 8 would also require the application of a consistent policy year on year unless the conditions for a change in policy were met (and that change in policy were accounted for as required by IAS 8).

49. Whilst the staff does not consider that the guidance in IAS 23 is sufficiently detailed to require the use of one method over another, the staff considers that the above disclosures, if properly applied, should be sufficient to allow users of

the financial statements to understand how the transactions are reflected in the reported financial performance and financial position.

Sufficiently narrow in scope?

50. The issue relates to an interpretation of a relatively narrow requirement of IAS 23. The staff therefore considers that the issue is sufficiently narrow.

51. However, as described above, it may be considered that the issue is so narrow to be application guidance.

Ability to reach a consensus

52. The staff notes that diverse views currently exist in practice as to how the portion of foreign exchange gains and losses that should be regarded as adjustments to borrowing costs should be calculated. If members strongly favour different methods of undertaking this calculation then the IFRIC may find it difficult to reach a consensus in a reasonable time.

53. So long as IFRIC members are able to find support for one or other of the methods of calculating the borrowing costs eligible for capitalisation, the staff considers that there is no reason why the IFRIC should not be able to reach a consensus on this issue.

Relationship with an IASB project

54. This issue does not relate to a currently ongoing IASB project. However, this issue was considered as part of the Board's recently completed project on borrowing costs.

55. In November and December 2006, the Board discussed the comments that it had received on its proposed changes to IAS 23. Those comments included one that '*the Board should include additional guidance on… the interaction between IAS 23 and IAS 39 with respect to derivatives relating to borrowings [and] the application of adjustments to interest for foreign exchange differences*'[3].

56. In response to these concerns, the December 2006 Board paper states:

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

[3] Source: November 2006 Board paper

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.

57. In its final version of the amendments to IAS 23, the Board decided not to include additional guidance.

58. This conclusion was consistent with the Board's previous discussions in November 2005 when the Board considered differences between US GAAP and IFRS in this area.

59. The staff paper from that meeting states:

    '…[the] IAS definition [of Borrowing Costs] is broader than that of US GAAP, as it encompasses "interest and other costs" (paragraph 4), such as exchange differences, to the extent regarded as an adjustment to interest costs. They are excluded under SFAS 34...If the Board decides to converge on this issue further analysis and preliminary discussions with the staff of the FASB would be needed.'

60. IASB *Update* from that meeting states:

    After considering the staff analysis the Board decided that in the short-term convergence project it would not address differences other than the issue of capitalising borrowing costs versus immediately recognising them as an expense.

61. The staff considers that the fact that the Board considered this issue as recently as December 2006 and concluded that it did not wish to include additional guidance in the standard suggests that the Board does not believe that further guidance is required.

62. The staff also notes that the comment letter suggesting that the Board include additional guidance on the treatment of foreign exchange movements described this as 'guidance on the application of the broad principles' further supporting the view that any detailed guidance developed in this area would be application guidance.

CONCLUSIONS

63. The staff considers that the issue is of widespread and practical relevance, and does result in divergence in practice. It could be argued that reducing divergence in this area would result in improved financial reporting.

64. However, the staff is concerned that producing detailed guidance on how to compute one element of the cost of a qualifying asset would be seen as producing detailed application guidance. It is hard to see how such detailed application guidance could be principle-based. It may also be difficult to develop guidance for the computation of such an amount that will provide relevant information in all situations.

65. The staff notes that IAS 23 requires the disclosure of the amount of borrowing costs capitalised and the rate used to determine the amount of borrowing costs eligible for capitalisation. In addition, IAS 1 requires that the policy for capitalising borrowing costs be disclosed. IAS 1 would also require a consistent policy to be applied year on year (unless the conditions for a change in accounting policy in IAS 8 were met).

66. The staff also notes the Board's recent reluctance to amend the standard to include such application guidance.

67. [Paragraph omitted from observer note].