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Project **Annual Improvements Process**

Topic **IAS 23R: *Borrowing costs* – meaning of "general borrowings"**

## Introduction

### *Objective of this paper*

1. The objective of this paper is to document the staff's analysis and recommendation on the issue. As such, this paper:

   (a) provides background information on this issue;

   (b) analyses the alternatives;

   (c) makes a recommendation on the approach that should be adopted;

   (d) provides preliminary agenda criteria assessment for the IFRIC;

   (e) assesses the issue against the Annual Improvements criteria; and

   (f) asks the Board whether they agree with the staff recommendation.

### *Background*

2. The revised IAS 23 (issued in March 2007), that requires borrowing costs incurred for the qualifying assets to be capitalised, was effective on 1 January 2009. IAS 23 paragraph 14 requires the entity to determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset, to the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset (the submitter refers them as "general borrowings").

3. In April 2009, the IFRIC received a request to add to the IFRIC agenda an issue with respect to IAS 23 *Borrowing Costs* (revised 2007), relating to what

borrowings comprise “general borrowings” for purposes of capitalisation of borrowing costs. This issue will be discussed at the IFRIC meeting in July.

4. The full text of the agenda request has been included as Appendix A.

***Issue***

5. Should/could a borrowing made to acquire a specific asset other than a qualifying asset (as defined in IAS 23) be excluded from general borrowings when assessing the amount of general borrowing costs that are to be capitalised?

## Staff Analysis

6. The submission points out two views:

   **View A**: Some take a view on the definition of general borrowings in paragraphs 14 and BC24 of IAS 23 as meaning that “**all**” borrowings other than borrowings made specifically for the purpose of obtaining a qualifying asset, have to be taken into account when calculating the capitalisation rate.

   **View B**: Others apply a view, allowing allocation between “general borrowings” and other borrowings made specifically for the acquisition of other assets. This view is based on the general principle in IAS 23 that an entity should capitalise borrowing costs that would have been avoided if the expenditure on the assets had not been made. Borrowings made specifically for the acquisition of other assets are excluded from the calculation of the capitalisation rate for general borrowings.

7. The staff suggest two possible approaches the Board could take. Approach 1 does not state that either View A or View B is correct but states that the issue is a matter of accounting policy choice requiring the exercise of judgement and consistent application. Approach 2 supports View B and suggests an amendment to paragraph 14.

***Approach 1***

8. The staff notes that IAS 23 paragraph 11 states “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.” The examples of such difficulty include the cases where an entity uses group cash management.

9. In the staff's view, such difficulty also exists in identifying the amount of borrowing costs that are directly attributable to the acquisition of a specific asset other than a qualifying asset.

10. Consequently, how an entity applies IAS 23 for purposes of capitalisation of borrowing costs is a matter of accounting policy requiring the exercise of judgement. IAS 1 *Presentation of Financial Statements* requires clear disclosure of significant accounting policies and judgements that are relevant to an understanding of the financial statements. If the Board supports this approach, no action is necessary. The IFRIC agenda decision should be sufficient.

***Approach 2***

11. The supporters of View B think that IAS 23 paragraph 14 seems to conflict with the general principle of IAS 23 paragraph 10. They take the view that borrowings made specifically for the acquisition of other assets (regardless of whether they are qualifying assets) are excluded from the calculation of the capitalisation rate for general borrowings. If the Board supports this approach, the staff believes IAS 23 should be amended.

| **Question 1 for the Board** |
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| The staff recommends approach 2. Which approach would the Board like to follow? |

## Agenda criteria assessment for the IFRIC

12. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) *Is the issue widespread and practical?*
    Yes. In the staff's view, the issue could arise in many jurisdictions when entities raise funds to purchase an asset other than a qualifying asset as well as general borrowings.

    (b) *Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?*
    (Approach 1) As the submission indicates, there could be some degrees of divergence in practice as many entities coordinate financing activities centrally on a pooled cash management basis. However, the standard itself acknowledges that judgement will be required in its

application and appropriate disclosure of accounting policies and judgements would provide users with the information they need to understand the financial statements.
(Approach 2) IAS 23 paragraph 14 seems to conflict with the general principle of IAS 23 paragraph 10. This conflict may trigger divergence in practice.

(c) *Would financial reporting be improved through elimination of the diversity?*
Depending on view on (b).

(d) *Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and the Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?*
No. The issue seems to be too narrow to develop an interpretation.

(e) *If the issue relates to a current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process.)*
N/A. There are no planned or current IASB projects that the issue relates to.

13. Based on the assessment of the agenda criteria in paragraph 12, the staff recommend that IFRIC not add the issue to its agenda.

## Annual Improvements criteria assessment

14. The staff does not believe that the issue meets the IFRIC's agenda criteria even though we conclude that it could result in diversity in practice. We believe that the most effective way to resolve it is for the Board to amend IAS 23 through the annual improvements project. We believe that this issue meets the annual improvements criteria of being a non-urgent but necessary amendment to IFRSs.

15. Accordingly, the staff recommend that the Board amend IAS 23 as a part of Annual Improvement project. The proposed amending wording is set out in Appendix B.

| Question 2 for the Board |
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| 1. Does the Board agree that the issue should be added to Annual Improvements project?<br><br>2. Do you have any comments in the proposed amendment to IAS 23 in Appendix B? |

# Appendix A – IFRIC potential Agenda Item Request

A1. The staff received the following IFRIC agenda request. All information has been copied without modification by the staff.

A2. [XXXX] request IFRIC to address the following issue with respect to IAS 23 *Borrowing Costs* (Revised 2007), relating to what borrowings comprise "general borrowings" for purposes of capitalisation of borrowing costs.

## The issue:

A3. Should/could a borrowing made to acquire a specific asset other than a qualifying asset (as defined in IAS 23) be excluded from general borrowings when assessing the amount of general borrowing costs that are to be capitalised?

A4. Guidance on capitalisation of borrowing costs incurred on general borrowings is addressed in paragraph 14 of IAS 23, which states: "To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period."

A5. Additionally, the last sentence of paragraph BC24 of IAS 23 states: "When an entity borrows funds generally and uses them to obtain a qualifying asset, IAS 23 permits some flexibility in determining the capitalisation rate, but requires an entity to use all outstanding borrowings other than those made specifically to obtain a qualifying asset."

A6. Consider the following two extreme scenarios:

A7. ***Scenario 1****:* During 20XX, an entity borrows 10 billion monetary units (MU) to finance its 10 billion MU equity investment in an associate. This investment in an associate is not a qualifying asset. Also during 20XX, the entity invested 2 billion MU to construct qualifying assets. Are the borrowings taken out to acquire the associate considered to be 'general borrowings' for the application of IAS 23?

A8. ***Scenario 2:*** A parent entity manages a centralised cash pooling function to support the various cash needs of its subsidiaries. As part of its cash management strategy, rather than repay the borrowings, the entity chooses to maintain a specified, significant level of cash in bank to ensure immediate liquidity. During 20XX, this parent entity borrows 2 billion MU at an annual borrowing cost rate of 10%, in addition to its already outstanding loan balance of 1 billion MU (which has a weighted average annual borrowing cost rate of 5%). It maintains an average cash investment balance of 2 billion MU throughout 20XX, on which it earns an average annual investment income return of 3%. The entity invests 2 billion MU to construct qualifying assets during 20XX. Are all of the borrowings considered 'general borrowings' for the application of IAS 23?

A9. In many situations, an entity will have several types of borrowings, which can include, for example, the following:

- borrowings made specifically for the purpose of obtaining a qualifying asset
- borrowings incurred for acquiring a specific non-qualifying asset (for example a business/associate)
- debt linked to a finance lease (specific non-qualifying asset)
- general borrowings that finance both qualifying assets (such as property, plant and equipment) and working capital requirements

## Current practice:

A10. Divergent views are beginning to emerge in practice, as noted below:

A11. ***View A:*** Some take a narrow view on the definition of general borrowings in paragraphs 14 and BC 24 of IAS 23 as meaning that "all" borrowings other than borrowings made specifically for the purpose of obtaining a qualifying asset, have to be taken into account when calculating the capitalisation rate and pool of borrowing costs that the amount capitalised shall not exceed. Proponents of view A would therefore conclude that, in both scenarios 1 and 2, the borrowings would be included in general borrowings.

A12. ***View B:*** Others apply a broader view, allowing allocation between "general borrowings" and other borrowings made specifically for the acquisition of other assets. Borrowings made specifically for the acquisition of other assets are excluded from the calculation of the capitalisation rate and pool of borrowing costs.

A13. Proponents of view B believe that inclusion of borrowings made specifically for non-qualifying assets (for example a business) in the calculation of borrowing costs to be capitalised contradicts the basic principle of capitalising borrowings costs in paragraph 10 of IAS 23, which states: "borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made." As these borrowings are specifically dedicated to the financing of non-qualifying assets, the conclusion is that they would have been incurred if no qualifying asset was acquired, hence they are not costs that 'would have been avoided'.

A14. Proponents of view B draw a distinction between borrowings taken out to acquire an asset other than cash, and cash investments as noted in scenario 2, on the basis that the cash investments are part of the cash management function. They also refer to paragraph 12 of IAS 23 which refers to a net approach only being applicable for specific borrowings.

A15. Proponents of view B therefore would conclude that, in scenario 1 above, the borrowings would not be considered general borrowings, while in scenario 2 above, the borrowings would be general borrowings.

A16. If view B is accepted, further considerations are:

(a) how to demonstrate that a borrowing is specific to non-qualifying assets:

(i) Should borrowings only be allocated to "specific" borrowings in situations where the link between the asset and the borrowing is established on a contractual basis?

(ii) Or, should it also allow for "linkage" based on all facts and circumstances, including indicators such as the amount, the currency and length of borrowing

(b) is the scope of paragraph 14 only relevant for determining the capitalisation rate or does it also extend to the limit on the borrowing costs that may be capitalised.

## Reasons for the IFRIC to address the issue:

A17. Capitalisation of borrowing costs is an emerging issue resulting from the newly effective requirement of IAS 23R to capitalise borrowing costs. Our survey of the 2005 IFRS financial statements of 65 major companies showed that a sizeable majority of those companies recognised borrowing costs as an expense (prior to the revisions to IAS 23 effective 1 January 2009), hence will be capitalising borrowing costs for the first time in 2009

A18. The specific issue of determining what comprises "general borrowings" is widespread, as many entities coordinate financing activities centrally on a pooled cash management basis.

A19. A clarification from the IFRIC would improve consistency in the application of this revised standard. As noted above, divergent views are beginning to emerge, and clarity what constitutes general borrowings is needed to ensure consistency with the general principles of IAS 23.

A20. We believe that the conceptual meaning of general borrowing costs can be resolved efficiently and in a timely manner by an interpretation from the IFRIC and that such clarification is within the scope of the IFRIC.

A21. We are not aware of any planned or current IASB project that would provide guidance on the meaning of general borrowings.

# Appendix B – Proposed amendment to IAS23

**[ Appendix omitted from observer note]**