Project	*Annual Improvements* Project – 2009 - 2011 cycle – Identification of issues
Topic	Capitalisation of borrowing costs and first-time application

Introduction

1. The Committee received a request in April 2010 asking for an improvement in IFRS 1 *First-time Adoption of International Financial Reporting Standards* to clarify the accounting for borrowing costs at the date of transition.
2. The text of the submission, amended to keep anonymous, and relevant literature are reproduced respectively in Appendices B and C for ease of reference.

Objective of the paper

3. The objective of this paper is to:
    (a) provide an analysis on the issue,
    (b) recommend the issue be included in the next *Improvements to IFRSs* exposure draft, and
    (c) propose wording in Appendix A for the proposed improvement.

The issue

4. The issue is about how to account, on the date of transition to IFRSs, for borrowing costs that were capitalised in accordance with previous GAAP but

where previous GAAP was inconsistent with IAS 23 *Borrowing costs* (as revised in 2007).

5. The revision of IAS 23 effective from 1 January 2009 removed the option for expensing borrowing costs. In addition, IFRS 1 provides for an exemption on the date of transition in paragraph D23 that enables an entity to apply the transitional provisions within IAS 23.

6. The transition provisions for existing as well as first-time preparers are set out in paragraphs 27 and 28 of IAS 23. They provide a relief on transition: <u>prospective</u> application to borrowing costs relating to <u>qualifying assets</u> for which <u>the commencement date for capitalisation is on or after the effective date</u>, when applying IAS 23 is a <u>change in accounting policy</u>.

7. In his analysis of the issue, the submitter assumes that the change of method of capitalisation is a change in accounting policy rather than a change in estimate and therefore paragraphs D23 of IFRS 1 and 27 of IAS 23 apply.

8. The submitter also believes the standard is clear when requiring capitalisation in accordance with IAS 23 be applied prospectively to all borrowing costs incurred after the date of commencement for capitalisation of all projects in progress at transition date (capitalisation should in any case cease in accordance with paragraph 22 of IAS 23). The staff is aware that the entity is permitted by paragraph 28 of IAS 23 to select an earlier date[1] than the date of transition.

9. However, the submitter questions whether for completed projects prior to the date of transition to IFRSs, costs previously capitalised in accordance with previous GAAP should be eliminated or “grandfathered”.

[1] For ease of reference, the analysis will assume this date is the date of transition to IFRSs. A date chosen before the date of transition should not impair the analysis.

Staff analysis

10. The staff notes that the transition provisions in IAS 23 and the exemption in IFRS 1 are silent on the application to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the transition date.

11. Given the absence of guidance, constituents are split in their views as to whether the carrying amount of capitalised borrowing costs under previous GAAP should be:

    (a) View 1: eliminated at the transition date,

    (b) View 2: retained (“grandfathered”) at the transition date.

12. Furthermore, for qualifying assets under construction at the date of transition and for which the commencement date for capitalisation is before the transition date, constituents hold different views as to the accounting for subsequent costs to be capitalised:

    (a) View A: subsequent capitalised costs should follow the requirements of IAS 23,

    (b) View B: subsequent capitalised costs should remain accounted for in accordance with previous GAAP, even though inconsistent with IAS 23.

Carrying amount of capitalised borrowing costs at the date of transition

13. The staff notes that paragraph 5 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* defines ‘prospective application’ as:

    > *Prospective application* of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:
    >
    > (a) applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and
    >
    > (b) recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

14. The staff can see some merits in view 1 that leads to eliminating balances determined in accordance with previous GAAPs that are not compliant with IFRSs. A transition balance of nil could enhance comparability compared to carrying over balances determined in accordance with various previous GAAPs.

15. Nonetheless, the intent in item (a) of the definition of 'prospective application' is at describing that no variation arise from the application of a new accounting policy at the date of change, hence no effect is to be recognised in the financial statements. In other words, carrying amounts determined in accordance with previous GAAP should be carried over to the statement of financial position at the date of transition.

16. The staff also notes that IAS 8 makes it clear that the effect of a retrospective application are recorded in retained earnings. By difference, the staff believes this supports the view that prospective application has no effect on the opening of the statement of financial position. The staff therefore supports view 2.

17. In addition, the staff believes that when the change in policy is from one method of capitalisation to another rather than from expensing borrowing costs to capitalising them, transition provisions should still be the same.

Subsequent borrowing costs for qualifying assets under construction at the date of transition

18. The staff notes that IFRS 1 only provides guidance for the accounting at the date of transition. Subsequent transactions and movements should be accounted for in accordance with the relevant IFRSs.

19. Because the context of the submission is one of first time adoption of IFRSs, the staff believes that borrowing costs subsequent to the date of transition and relating to qualifying assets under construction at the date of transition for which the commencement date for capitalisation is before the transition date should be accounted for in accordance with IAS 23. Therefore, the staff considers view A as the appropriate answer.

20. View B would have the effect of carrying over accounting principles that are inconsistent with IAS 23 for qualifying assets under construction at the date of transition. The financial statements would show borrowing costs recorded and measured using different bases and comparability and consistency would be impaired.

Conclusion

21. The staff agrees that the current transition provisions could be clarified and give more explicit guidance that would enhance consistency in practice. The staff thinks that this additional guidance should be given for qualifying assets for which the commencement date of capitalisation is before the transition date whether they are under construction or completed at the date of transition.

Staff recommendation

22. Therefore, the staff recommends the following sentences be added to paragraph D23 of IFRS 1:

> The carrying amount of borrowing costs in the opening IFRS statement of financial position shall be its carrying amount in accordance with previous GAAP at the date of transition to IFRSs. From this date, the accounting for borrowing costs should follow the requirements in IAS 23.

23. The staff is of the opinion that no consequential amendment to IAS 23 is needed on the grounds that the effective date has now passed. In other words, the proposed amendment is only relevant for first-time adopters.

Question 1 – Staff recommendation
Does the Committee agree with the staff recommendation to clarify that on transition, when changing accounting policy to comply with IAS 23, the carrying amount of borrowing costs capitalised in accordance with previous GAAP should be retained in the opening statement of financial position?

Does the Committee agree with the staff recommendation to clarify that all subsequent borrowing costs be capitalised in accordance with IAS 23? Does the Committee agree that no consequential amendment should be made to IAS 23 for the reasons given in paragraph 23?

24. The wording for the proposed amendment is set out in Appendix A to this paper.

Question 2 – Proposed wording
Does the Committee agree with the wording for the proposed amendment as set out in Appendix A? If not, what wording would the Committee suggest?

Assessment against *Annual Improvements* criteria

Assessment against currently used criteria

25. The existing criteria for inclusion in the 2009-2011 *Annual Improvements* cycle are that the change is non-urgent and necessary.

26. The staff believes the proposed clarification of the transition requirements in paragraph D23 of IFRS 1 meets these criteria in that it does not propose to introduce a new accounting principle. In addition, the proposed change enhances the quality of financial information.

Proposed new criteria

27. The Trustees have asked the Board to present enhanced criteria in determining the scope for the *Annual Improvements* process. This request is in response to comments received from constituents regarding appropriateness of criteria for judging whether an issue is an *Annual Improvement*.

28. At this stage, given the proposed new criteria are still to be finalised, the staff assesses inclusion in 2009-2011 *Annual Improvements* cycle with regards to the

current criteria only. The staff will update the assessment accordingly prior to the publication of the exposure draft.

29. The staff recommends the change proposed in paragraph 22 be included in the 2009-2011 *Annual Improvements* cycle.

Question 3 – Assessment of improvements against criteria for inclusion in *Annual Improvements*
Does the Committee agree that the proposed improvement in paragraph 22 meets the current criteria for inclusion in *Annual Improvements*?

Appendix A – Drafting for proposed amendment

A1. This appendix includes proposed drafting of the proposed amendment. It is based on the text included in the Bound Volume as of 1 January 2010. New text is underlined and deleted text is struck through.

Proposed amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards*

Paragraph 39F is added. In Appendix D, paragraph D23 is amended.

Effective date

39F *Improvements to IFRSs* issued in [date] amended paragraph D23. An entity shall apply this amendment for annual periods beginning on or after 1 January 2012. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Appendix D
Exemptions from other IFRSs

Borrowing costs

D23 A first-time adopter may apply the transitional provisions set out in paragraphs 27 and 28 of IAS 23, as revised in 2007. In those paragraphs references to the effective date shall be interpreted as 1 January 2009 or the date of transition to IFRSs, whichever is later. The carrying amount of borrowing costs in the opening IFRS statement of financial position shall be its carrying amount in accordance with previous GAAP at the date of transition to IFRSs. From this date, the accounting for borrowing costs should follow the requirements in IAS 23.

Basis for Conclusions on proposed amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards*

This Basis for Conclusions accompanies, but is not part of, the proposed amendment.

Borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before transition date

BC1 Concerns were raised by first-time adopters on the transition provisions for borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the date of transition. Before this proposed amendment, constituents found it unclear whether balances in accordance with previous GAAPs should be retained or eliminated in the opening statement of financial position. Constituents also questioned the accounting, subsequent to transition date, for capitalised borrowing costs relating to such qualifying assets when these qualifying assets are under construction at the date of transition. Therefore, the Board proposes to clarify that such balances should be carried over in the opening statement of financial position. Such balances should not be eliminated as this would entail an impact on retained earnings inconsistent with the effects of a prospective application. In addition, the Board proposes to clarify that borrowing costs subsequent to the date of transition should be accounted for in accordance with IAS 23 whether they relate to qualifying assets that are under construction or completed at the date of transition.

Appendix B – Submission

IFRS 1 & IAS 23: Capitalisation of Borrowing Costs

The issues raised are:

1. Is the entity required to restate its borrowing costs retrospectively on adopting IFRSs, or does IFRS 1 permit prospective application?

2. If prospective application is permitted, for on-going projects, does the entity apply capitalisation in accordance with IAS 23: (i) to all *costs* incurred after the date of transition to IFRSs; or (ii) to costs relating to *projects* commenced after the date of transition to IFRS?

3. If prospective application is permitted, for completed projects, are costs previously capitalised in accordance with local GAAP: (i) eliminated; or (ii) "grandfathered"?

On the first issue, the change in the method of capitalisation is a change in accounting policy rather than a change in estimate. Consequently, IFRS 1 permits prospective application.

On the second issue, common thinking is that the unit of account is the *project*. It was noted that IAS 23, paragraph 28, allows an entity to choose to use an earlier date rather than being tied to the date of transition to IFRSs. As a result, the entity may apply the new method of capitalisation prospectively to all borrowing costs incurred subsequent to the date of commencement for capitalisation of all projects underway at the date selected.

On the third issue, views are split. Some think that if the entity elects prospective application of IAS 23, it must eliminate costs previously capitalised under national GAAP to satisfy the specific requirements of IFRS 1. Others note that this interpretation is contrary to the intent of IFRS 1 and the transition requirements of IAS 23, to provide relief from burdensome retrospective restatement.

Our understanding is that there is diversity of practice on this issue internationally, including a difference of view between 1 of the largest international accounting networks compared to the other three. We also expect that there is likely to be divergence in practice on this issue on adoption of IFRS in our jurisdiction. We think that the intent of IFRS 1 and IAS 23 is to provide relief from burdensome restatement in this case, but acknowledge that it may be difficult to reach that conclusion with the words as written.

Although we think that the effect of the different capitalisation methods would often be immaterial, this may not always be the case. Besides, auditors usually insist that entities actually do the necessary calculations to demonstrate that the effect is immaterial. In addition, the lack of clarity on this issue appears to be consuming considerable time for entities and their advisors that could usefully be spent on more important transition issues.

We note that in the IAS 23 transition requirements, the Board considered only the change from expensing to capitalizing borrowing costs using the IAS 23 methodology, because those were the only options available to an existing IFRS user. The Board concluded that requiring retrospective restatement did not meet a cost/benefit test for the change that arguably would have the most significant effect on reported assets and income. We do not believe that the Board would reach a different conclusion if it specifically addressed the question of changing from one method of capitalisation to another.

Accordingly, we request that, as part of the annual improvements project, the Board amend paragraph D23 of IFRS 1 to clarify that it is not necessary to restate prior balances when borrowing costs have been capitalised in accordance with previous GAAP using a method inconsistent with IAS 23. We believe this amendment would simply implement the Board's rationale that the cost versus benefits is not justified.

DETAILED ANALYSIS

Purpose

1. To consider the treatment, on first-time adoption of IFRSs, of borrowing costs previously capitalised using a method inconsistent with IAS 23, and whether a request should be made to the IFRIC for clarification of the appropriate accounting treatment.

The Issues

2. Some entities have previously capitalised borrowing costs but using a method that is inconsistent with IAS 23. The issues are:

(a) Is the entity required to retrospectively restate its borrowing costs on adopting IFRSs, or does IFRS 1 permit prospective application?

(b) If prospective application is permitted, for ongoing projects, does the entity apply capitalisation in accordance with IAS 23: (i) to all costs incurred after the date of transition to IFRSs; or (ii) to costs relating to projects commenced after the date of transition to IFRSs[2]1?

(c) If prospective application is permitted, for completed projects, are costs previously capitalised in accordance with local GAAP: (i) eliminated; or (ii) "grandfathered"?

[2] IFRS 1/IAS 23 also allows use of an earlier date of the enterprise's choosing (IAS 23.28), but this is set aside for this analysis.

Analysis

First issue

3. The key consideration in the first issue seems to be whether a change in the method of capitalisation is a change in accounting policy. If so, it seems relatively clear that an entity may use the combination of IFRS 1.D23 and IAS23.27 to apply the new accounting policy to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the date of transition to IFRSs, i.e., prospectively.

4. The Basis for Conclusions to IAS 23, paragraph BC15, discusses only a change in accounting policy from immediately recognising borrowing costs as an expense to capitalising them. It does not discuss a different method of capitalisation. This is because that was the only option for existing IFRS users–IAS 23 only allows for one method of capitalisation.

5. The Basis for Conclusions to IFRS 1, paragraph BC63E, similarly discusses only the difficulty of not having gathered necessary information when changing from immediate expense recognition to capitalisation. It acknowledges the difficulty of gathering information in that situation, but does not mention difficulties in changing the method of capitalisation.

6. Our understanding is that there is a range of interpretations of this issue taken by the Big 4 accounting Firms, with some allowing for prospective application, but others requiring retrospective restatement. It might be argued that the former is consistent with the “spirit” of the standard, but the latter is consistent with the precise words.

Second issue

7. On the second issue, some people read the words in IAS 23.27, “an entity shall apply the standard to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the date of transition to IFRS,” as specifying that if the borrowing costs occur after the date of transition to IFRSs they should be capitalised — but not for those occurring before the date of transition to IFRSs.

8. Others view the unit of account to be the project, and place more emphasis on the words that the *qualifying asset* for which the commencement date for capitalisation occurs after the date of capitalisation. They would require that all borrowing costs relating to a qualifying asset for which construction commences before the date of transition to IFRSs continue to be accounted for in accordance with previous GAAP and only costs related to new projects be accounted for in accordance with IAS 23.

Third issue

9. On the third issue, some think that an entity should *expense* all borrowing costs capitalised in a manner inconsistent with IFRSs that relate to qualifying assets for which construction commenced before the date of transition to IFRS. They argue that the

transitional requirements provide relief from retrospective application only for an entity that expensed borrowing costs previously, not for a different method of capitalisation. In addition, they argue that the opening balance sheet is to be prepared in accordance with IFRSs and that IFRS 1 does not explicitly permit the "grandfathering" of borrowing costs capitalised in accordance with previous GAAP.

10. Others think that borrowing costs capitalised in a manner inconsistent with IFRSs that relate to qualifying assets for which construction commenced before the date of transition to IFRSs may be "*grandfathered'*. They argue that the intent of the relief provided by IFRS 1 was to alleviate the need to restate past borrowing costs capitalised. The fact that only a change from expensing to capitalisation is discussed in the basis for conclusions is a result of consideration of previous reporting required by IAS 23 before it was modified effective in 2009. They argue that it is not intended to prevent application to a change in method of capitalisation.

Conclusion

11. We think that a clarification by the IFRIC would be desirable. The IFRIC agenda criteria are evaluated below. We think that the issues meet those criteria.

12. We note, also, that the following issue was identified in comment letters on the proposed amendments to IFRS 1, exposed in September, 2008 and ultimately issued in July 2009[3].

"… it would be helpful if the Board could clarify its intent with respect to the interaction of the IAS 23 (2007) transitional requirements and the related IFRS 1 exemption. Diversity in practice may result if some entities misinterpret the exemption as to whether or not a first-time adopter should grandfather, in the carrying amount of a qualifying asset whose construction is complete at the transition date, borrowing costs capitalised to such asset under previous GAAP using a methodology that differs from IAS 23."

13. The staff analysis reported to the IASB was that:

"This issue goes beyond IFRS 1. Staff are aware of other inquiries regarding the transitional provisions for borrowing costs, and recommend that this issue be referred to the Annual Improvements project team for possible consideration."

IFRIC Criteria

1.Is the issue widespread and practical?

The issue has arisen, not only in our jurisdiction, but also elsewhere – the issue was originally brought to our attention from London during the course of developing the amendments to IFRS 1, issued in July 2009. It is a practical issue that first-time adopters are facing.

[3] See IASB Agenda Paper 18, May 2009

2.Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As noted above, there appear to be divergent views, each of which results in different accounting treatment. These views have prevailed, at least to our knowledge, for at least a year or more.

3.Would financial reporting be improved through elimination of the diversity?

Elimination of the diversity would enhance the consistency of application on first-time adoption, as well as the subsequent accounting until the construction in process at the date of transition to IFRSs is complete.

4.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 interpretations process?

Yes.

5.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.)

We are not aware of any current or planned IASB project that would address this issue.

Appendix C – Relevant IFRS literature

IAS 23 *Borrowing costs*

27 When application of this Standard constitutes a change in accounting policy, an entity shall apply the Standard to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the effective date.

28 However, an entity may designate any date before the effective date and apply the Standard to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

Commencement of capitalisation

17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

Basis for Conclusions on IAS 23 *Borrowing costs*

BC15 Development of a qualifying asset may take a long time. Additionally, some asset currently in use may have undergone and completed their production or construction process many years ago. If the entity has been following the accounting policy of immediately recognising borrowing costs as an expense, the costs of gathering the information required to capitalise them retrospectively and to adjust the carrying amount of the asset may exceed the potential benefits. Hence, the Board decided to require prospective application, which was supported by respondents to the exposure draft.

BC16 The Board noted that the revisions would result in information that is more comparable between entities. On that basis, if an entity wished to apply the revised Standard from any date before the effective date, users of the entity's financial statements would receive more useful and comparable information than previously.

BC17 Therefore, an entity is permitted to apply the revised Standard from any designated date before the effective date. However, if an entity applies the Standard from such an earlier date, it should apply the Standard to all qualifying assets for which the commencement date for capitalisation is on or after that designated date.

BC63E IAS 23 *Borrowing Costs* (as revised in 2007) contains transitional provisions because the Board acknowledged that if an entity has been following the accounting policy of immediately recognising borrowing costs as an expense and has not previously gathered the necessary information for capitalisation of borrowing costs, getting the information retrospectively may be costly. First-time adopters of IFRSs face problems similar to those facing entities that already apply IFRSs. Moreover, although first-time adopters have the option of using fair value as the deemed cost of an asset at the date of transition to IFRSs, this option is not applicable to all qualifying assets, such as inventories. Furthermore, the Board concluded that the existence of the deemed cost option is not sufficient to justify a more stringent requirement for the application of IAS 23 for first-time adopters than for entities that already apply IFRSs. A more stringent requirement for the adoption of the capitalisation treatment could be justified when IFRS 1 was originally issued because capitalisation was then an option. The requirements for the application of mandatory capitalisation, on the other hand, should be the same for entities that already apply IFRSs and for first-time adopters. Therefore, the Board decided to amend IFRS 1, allowing first-time adopters transitional provisions equivalent to those available to entities that already apply IFRSs in paragraphs 27 and 28 of IAS 23, as revised in 2007.