

STAFF PAPER

17 January – 18 January 2012

IFRS Interpretations Committee Meeting

[this box can be used to give additional meeting dates]

Project	2009-2011 Annual improvements cycle (ED June 2011)— Comment letter analysis		
Paper topic	IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i> — Borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the date of transition to IFRSs		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The exposure draft of proposed *Improvements to IFRSs* published in June 2011 includes a proposal for an amendment to the exemption for borrowing costs in paragraph D23 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* that would clarify the transitional provisions that a first-time adopter may apply to account for borrowing costs for which the commencement date for capitalisation is before the date of transition to IFRSs.

Objective of this paper

2. The objective of this paper is to provide an analysis of the comment letters received on the proposal to amend paragraph D23 and to obtain a final decision from the IFRS Interpretation Committee (the ‘Committee’) to allow this issue to be included in the final *Improvements to IFRSs* planned to be issued in 2012.

Structure of this paper

3. This agenda paper:
 - (a) provides background information on the issue;
 - (b) analyses the comments received as part of the exposure draft process and recommends changes to the proposed draft wording; and
 - (c) asks the Committee to confirm whether they agree with the staff recommendation to proceed with the proposed amendment by adding some further changes that would make the proposed amendment clearer.

Background

Current guidance in IFRS 1 and IAS 23 regarding the accounting for borrowing costs

4. The transitional provisions for accounting for borrowing costs are set out in paragraphs 27 and 28 of IAS 23 *Borrowing Costs*.
 - (a) Paragraph 27 provides a relief on transition, because it requires prospective application of the accounting for borrowing costs relating to qualifying assets for which the commencement date¹ for capitalisation is on or after the effective date.
 - (b) Paragraph 28 allows an entity to apply the requirements in IAS 23 from an earlier date.
5. Paragraph D23 of IFRS 1 provides guidance for the accounting for borrowing costs for first-time adopters at the date of transition. This paragraph states that a

¹ Paragraph 17 of IAS 23 defines the commencement date for capitalisation as 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.

first-time adopter may apply the transitional provisions set out in paragraphs 27 and 28 of IAS 23. The references in those paragraphs to ‘effective date’ shall be interpreted as the ‘date of transition to IFRSs’, which means that if a first-time adopter applies IAS 23:

- (a) from the date of transition, it should capitalise borrowing costs on qualifying assets for which the commencement date is on or after the transition date.
- (b) from an earlier date, it should capitalise borrowing costs on qualifying assets for which the commencement date is on or after the earlier date selected.

Issue raised that led to the proposed amendment

- 6. Constituents observed that the transition provisions of both IAS 23 and paragraph D23 of IFRS 1:
 - (a) are silent on whether borrowing costs capitalised in accordance with previous GAAP (this is, before the transition date) for completed projects should be eliminated or be carried forward at the transition date; and
 - (b) are not clear on the accounting for borrowing costs for assets under construction at the transition date.
- 7. Consequently, the Board was asked to clarify the two issues above in paragraph D23 of IFRS 1.

The Board's proposal to address the issues raised

- 8. To address these concerns, in May 2010 the Committee, recommended to the Board that they should clarify the exemption for borrowing costs in paragraph D23 of IFRS 1 (refer to Agenda Paper 9²). At the Board meeting in July 2010³,

² <http://www.ifrs.org/NR/rdonlyres/7696157A-CD77-442F-A7AD-207B0AAB62DC/0/1005ap9obsAIPCcapitalisationofborrowingcostsandFTA.pdf>

³ <http://www.ifrs.org/Meetings/IASB+Board+Meeting+21+July+2010.htm> Agenda Paper 14A

the Board agreed with the Committee's proposal to include an amendment to paragraph D23 of IFRS 1 as part of the 2009–2011 *Annual Improvements* cycle.

9. The Board proposed to clarify that:
- (a) an entity will not be required to restate the borrowing costs component of assets determined in accordance with previous GAAP at the date of transition; consequently, capitalised borrowing costs determined under previous GAAP should be retained at the transition date; and
 - (b) borrowing costs on qualifying assets incurred on or after the date of transition, including those that relate to qualifying assets under construction at the date of transition, are to be accounted for in accordance with IAS 23. However, an entity may still choose to apply IAS 23 from an earlier date.
10. The proposed amendment to paragraph D23 of IFRS 1 is reproduced below for ease of reference:

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. An entity electing to apply this exemption can choose to apply the requirements in IAS 23 from an earlier date as permitted by paragraph 28 of IAS 23. From the date on which an entity applying this exemption applies IAS 23, it:

(a) shall not restate the borrowing cost component that was capitalised under previous GAAP and included in the carrying amount of assets at that date; and

(b) shall account for borrowing costs incurred on or after that date, including those incurred on or after that

date on qualifying assets already under construction, in accordance with IAS 23.

11. In this paper, we discuss and analyse the comments received from constituents during the comment period, which ended on 21 October 2011.

Comment letter analysis

12. The Board received 67 comment letters on the exposure draft (ED). The ED asked two questions:
 - (a) Question 1: Do you agree with the Board's proposal to amend the IFRS as described in the exposure draft? If not, why and what alternative do you propose? [52 respondents answered this question]
 - (b) Question 2: Do you agree with the proposed transitional provisions and effective date for the issue as described in the exposure draft? [48 respondents answered this question]

Main concerns identified

13. A majority of respondents agree in principle with the proposal to clarify in paragraph D23 of IFRS 1 the transitional provisions that a first-time adopter may apply to account for borrowing costs for which the commencement date for capitalisation is before the date of transition to IFRSs.
14. However, some respondents⁴ think that the drafting of the proposed amendment in paragraph D23(b) is not sufficiently clear and may confuse some readers.

Requirements for first-time adopters seem to be stricter

15. Confusion mainly arises because the proposed amendments to paragraph D23 in IFRS 1 appear to require a first-time adopter that had previously recognised borrowing costs as an expense to begin to capitalise borrowing costs in respect of

⁴ See Comment Letter (CL) 5 (Deloitte), CL 21 (BDO), CL 27 (KASB), CL 31 (Grant Thornton), CL 33 (MASB), CL 40 (Moore Stephens), CL 52 (AcSB) and CL 59 (Hong Kong Institute of CPA)

qualifying assets under construction at the date of transition. Some respondents⁵ point out that this is inappropriate because existing IFRS reporters are not required to do so on adoption of IAS 23. In their view, this seems to be a stricter requirement to first-time adopters than for existing IFRS reporters.

16. They claim that their understanding is that a first-time adopter that had previously recognised borrowing costs as an expense, and that elects to apply the exemption in IFRS 1.D23, would only begin to capitalise borrowing costs on qualifying assets for which the commencement date for capitalisation is on or after the effective date.

References to the transition provisions in IAS 23 are confusing

17. Two respondents (CL 21 BDO, and CL 52 AcSB) question whether the transitional relief in IFRS 1 should refer to the transition provisions in IAS 23, because they seem to be inconsistent.
18. One respondent (CL 21 BDO) indicates that the transitional relief in IFRS 1 paragraph D23 overrides the requirements in paragraph 27 of IFRS 1, because the latter paragraph only applies to those assets for which the commencement date for capitalisation is on or after the effective date. Consequently, this respondent thinks that the direct reference to the transitional provisions of IAS 23 paragraph 27 is not appropriate.
19. Another respondent (CL 52 ACsB) notices some degree of contradiction between the amendment in paragraph D23(b) with paragraph 28 of IAS 23, because paragraph 28 states that an entity may designate ‘any date before the effective date’ to apply the IAS 23 to borrowing costs, whereas paragraph D23(b) permits capitalisation of borrowing costs incurred on or after transition date on qualifying assets including those already under construction. To avoid confusion, the respondent suggests deleting the reference to paragraph 28 of IAS 23 in paragraph D23. However, paragraph D23 would still indicate the possibility of applying the transitional provisions in paragraph 27 of IAS 23 at an earlier date.

⁵ See CL 5 (Deloitte) and CL 40 Moore Stephens.

20. This same respondent (CL 52) also notes that the term ‘under construction’ is not consistent with the terminology in IAS 23 and could be ‘interpreted narrowly to apply to construction-type projects only’.

Wording of Basis for Conclusions is unclear

21. A few respondents⁶ also note that another reason why the Board’s intention is unclear is because the proposed wording of paragraph D23(a) is not consistent with the proposed wording of paragraph BC6, because while:
- (a) paragraph D23(a) states that an entity ‘shall not restate the borrowing cost component that was capitalised under previous GAAP...’,
 - (b) paragraph BC6 states that: ‘Therefore, the Board proposes to clarify that borrowing costs capitalised in accordance with previous GAAP can be carried over in the opening statement of financial position...’. One respondent (CL 28) suggests that in this phrase ‘can’ should be replaced with ‘should’.
22. Respondents ask the Board to clarify its intention about the transition relief for first-time adopters in paragraph D23 in IFRS 1.

Transition and effective date

23. Respondents did not raise any further concerns with the proposed transitional provisions and effective date for the issue described in this paper.

Staff analysis

24. Our understanding of the Board’s proposals for applying the proposed exemption in paragraph D23 is that:
- (a) a first-time adopter that capitalised borrowing costs under previous GAAP, can carry them over in the opening statement of financial position. However it cannot continue to capitalise borrowing costs

⁶ See CL 5 (Deloitte) and CL 28 (PWC)

incurred after the date of transition using its previous GAAP, because its previous GAAP for borrowing costs might be inconsistent with IAS 23;

- (b) a first time adopter shall account borrowing costs incurred on or after the date of transition for qualifying assets under construction at date of transition, in accordance with IAS 23.

25. The following fact pattern illustrates our views:

Entity A is constructing a property that will be used as its head office building. This property will be completed in 20X5. Entity A has an accounting policy of capitalising borrowing costs directly attributable to the property as part of the cost of the asset using its local GAAP, which requires the capitalisation of the debt borrowing costs incurred, and an imputed cost of equity.

At 1 January 20X1, Entity A adopts IFRS 1 as first-time adopter. This date is considered as the date of Entity A's transition to IFRSs.

At 1 January 20X1, Entity A has capitalised borrowing costs of CU 500 under its local GAAP. This amount comprises CU 350 of debt costs and CU150 of imputed equity costs.

During 20X1, the debt costs attributable to the property under construction are CU 130 and the imputed equity costs are CU 85 (the debt costs of CU 130 is the amount that would be capitalised from the application of IAS 23 in 20X1).

What should be the accounting for Entity A's borrowing costs incurred before and after 1 January 20X1 if Entity A applies the exemption in paragraph D23 of IFRS 1?

1. Entity A will not restate its accounting for borrowing costs incurred before 1 January 20X1 (transition date). Consequently, at 1 January 20X1, Entity A carries forward an amount of CU 500 for capitalised borrowing costs relating to qualifying assets.

2. Entity A will apply IAS 23 for the accounting of borrowing costs incurred on or after 1 January 20X1 for its property that is still in construction and that will be completed in 20X5. It will therefore capitalise CU 130. It will not capitalise the CU 85 imputed costs of capital because IAS 23 does not permit these costs to be capitalised.

26. We also think that the Board's proposals are unclear on the accounting treatment for a first-time adopter that did not capitalise borrowing costs under previous GAAP.
27. The question is: should a first-time adopter *continue to recognise borrowing costs as an expense in relation to qualifying assets for which the commencement date for capitalisation is before the transition date?*
28. We think that a first-time adopter that did not capitalise borrowing costs under previous GAAP should begin to capitalise these costs in accordance with IAS 23, when adopting the transition relief in IFRS 1 paragraph D23, because borrowing costs incurred after transition date should be accounted for in accordance with IAS 23. We note that this requirement might be stricter than for existing preparers because first-time adopters that have recognised borrowing costs as an expense in accordance with previous GAAP will have to start capitalising them from the date of transition for projects that are under construction at transition date, while existing preparers, according to paragraph 27 of IAS 23, may continue to recognise the borrowing costs in profit or loss.
29. We think that the reference to paragraph 27 of IAS 23 is inappropriate, because it means that for an entity that did not previously capitalise borrowing costs, IAS 23 will only be applied to qualifying assets for which the commencement date is on or after the effective date of IAS 23. We think that a first-time adopter should apply IAS 23 to all qualifying assets that are under construction at its transition date, regardless of whether its previous accounting policy was to capitalise borrowing costs or not.
30. We think that a first time adopter should be allowed to apply IAS 23 from a date that is before transition. We therefore believe that the reference to paragraph 28 of IAS 23 is appropriate.

Staff recommendation

31. We propose deleting the reference to paragraph 27 of IAS 23 because, as we explain above, we think that it is inappropriate and leads to confusion.

32. We propose clarifying that a first time adopter shall account for borrowing costs for qualifying assets under construction on or after the date of transition in accordance with IAS 23.
33. We also propose deleting the term ‘under construction’ in the proposed paragraph D23(b) because this could be misinterpreted.
34. Regarding the proposed Basis for Conclusions section, we think that the Committee should recommend to the Board that it should modify the proposed wording of paragraph BC6 in order to clarify that:
- (a) when an entity chooses to apply the exemption in paragraph D23 of IFRS 1, borrowing costs capitalised in accordance with previous GAAP should be carried over in the opening statement of financial position, except if an earlier date is chosen; and
 - (b) an entity should account for borrowing costs incurred after the date of transition that relate to qualifying assets under construction at the date of transition in accordance with IAS 23 regardless of whether the entity capitalised or recognised in profit and loss borrowing costs under previous GAAP.
35. Our recommended changes to the draft wording and a draft Basis for Conclusions are included as appendices, as follows:
- (a) **Appendix A** shows the proposed amendment, including the staff’s recommendations in this paper, highlighting differences from the currently effective standard; and
 - (b) **Appendix B** shows proposed revisions to the wording in the previously published exposure draft, following the staff’s recommendations in this paper.

Questions – Borrowing costs exemption

1. Does the Committee agree to recommend to the Board to proceed with the proposed amendments as explained in our staff recommendation in paragraphs 31–34?
2. Does the Committee agree with the proposed amendment in Appendix A? If not, what does the Committee recommend?

Appendix A—Draft wording of the proposed amendment, showing differences from the currently effective standard

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

In Appendix D paragraph D23⁷ is amended as follows (new text is underlined and deleted text is struck through):

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. An entity electing to apply this exemption can choose to apply the requirements of IAS 23 from the date of transition or an earlier date as permitted by paragraph 28 of IAS 23. From the date on which an entity applying this exemption begins applying IAS 23, it:~~
- (a) shall not restate the borrowing cost component that was capitalised under previous GAAP and included in the carrying amount of assets at that date.
 - (b) shall account for borrowing costs incurred on or after that date in accordance with IAS 23, including those incurred on qualifying assets that met the criteria for the commencement of capitalisation before the date on which the entity applies this exemption.

⁷ An “Effective date” paragraph would also be added as a consequence of this amendment. This paragraph is included in Appendix A of agenda paper 10A (January 2012).

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

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

Paragraphs BC63F and BC63G are added.

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

BC63F Concerns were raised by first-time adopters about the transitional provisions for borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the date of transition to IFRSs. Constituents find it unclear whether borrowing costs capitalised in accordance with previous GAAP should be retained, restated or eliminated in the opening statement of financial position. Constituents also questioned the accounting, after the date of transition, for capitalised borrowing costs relating to such qualifying assets when these qualifying assets are under construction at the date of transition. They sought clarification as to whether the first-time adopter should apply the requirements of IAS 23 *Borrowing Costs* or whether it should continue applying its previous GAAP even though that previous GAAP is not consistent with IAS 23.

BC63G Consequently, the Board decided to clarify that when the entity chooses to apply the exemption in paragraph D23, borrowing costs that were capitalised in accordance with previous GAAP should be carried over in the opening statement of financial position. In addition, the Board decided to clarify that an entity should account for borrowing costs incurred after the date of transition that relate to qualifying assets under construction at the date of transition in accordance with IAS 23 regardless of whether the entity capitalised or recognised in profit and loss borrowing costs under previous GAAP. Some had understood that an entity should continue to capitalise borrowing costs using the entity's previous GAAP for borrowing costs relating to qualifying assets under construction at the date of transition. Others had understood that an entity should recognise in profit or loss borrowing costs using the entity's previous GAAP for borrowing costs relating to qualifying assets under construction at the date of transition.

Appendix B—Draft wording showing changes from the exposure draft published in June 2011 following our recommendations in this paper

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

In Appendix D paragraph D23 is amended as follows (for ease of reference new text is underlined and deleted text is struck through):

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.~~ An entity electing to apply this exemption can choose to apply the requirements of IAS 23 from the date of transition or an earlier date as permitted by paragraph 28 of IAS 23. From the date on which an entity applying this exemption begins applying ~~applies~~ IAS 23, it:
- (a) shall not restate the borrowing cost component that was capitalised under previous GAAP and included in the carrying amount of assets at that date; ~~and~~.
 - (b) shall account for borrowing costs incurred on or after that date in accordance with IAS 23, including those incurred on or after that date on qualifying assets already under construction in accordance with IAS 23 that met the criteria for the commencement of capitalisation before the date on which the entity applies this exemption.

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

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

Paragraphs BC63F and BC63G are added.

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

BC563F Concerns were raised by first-time adopters about the transitional provisions for borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the date of transition to IFRSs. Constituents find it unclear whether borrowing costs capitalised in accordance with previous GAAP should be retained, restated or eliminated in the opening statement of financial position. Constituents also questioned the accounting, after the date of transition, for capitalised borrowing costs relating to such qualifying assets when these qualifying assets are under construction at the date of transition. They sought clarification as to whether the first-time adopter should apply the requirements of IAS 23 *Borrowing Costs* or whether it should continue applying its previous GAAP even though that previous GAAP is not consistent with IAS 23.

BC63G ~~Therefore~~ ~~Consequently~~, the Board ~~proposes~~ decided to clarify that when the entity chooses to apply the exemption in paragraph D23, borrowing costs that were capitalised in accordance with previous GAAP should ~~can~~ be carried over in the opening statement of financial position. When the entity chooses to apply the exemption in paragraph D23, capitalised borrowing costs are not eliminated. The Board noted that eliminating such costs would affect retained earnings and would be inconsistent with the effects of prospective application. In addition, the Board ~~proposes~~ decided to clarify that an entity should account for borrowing costs incurred after the date of transition that relate to qualifying assets under construction at the date of transition in accordance with IAS 23 regardless of whether the entity capitalised or recognised in profit and loss borrowing costs under previous GAAP. Some had understood that an entity should continue to capitalise borrowing costs using the entity's previous GAAP for borrowing costs relating to qualifying assets under construction at the date of transition, ~~are to be accounted for in accordance with IAS 23~~ Others had understood that an entity should recognise in profit or loss borrowing costs using the entity's previous GAAP for borrowing costs relating to qualifying assets under construction at the date of transition.