IFRS

STAFF PAPER

14 July 2015

IFRS Interpretations Committee Meeting

Project	**IAS 23 *Borrowing Costs***		
Paper topic	Borrowing costs on completed qualifying assets		

CONTACT(S)	Jawaid Dossani	jdossani@ifrs.org	+44 (0)20 7332 2742

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request seeking clarification on whether funds borrowed specifically to finance the construction of a qualifying asset, the construction of which has now been completed, *must* be included as part of general borrowings for the purposes of determining the capitalisation rate for other qualifying assets under IAS 23 *Borrowing Costs.*

2. The submitter described a scenario in which:

   (a) an entity borrows funds specifically to finance the construction of a qualifying asset;

   (b) the activities necessary to prepare the asset for its intended use or sale have now been completed;

   (c) the borrowing that was made specifically to finance the construction of that qualifying asset has not been fully repaid; and

   (d) there are other qualifying assets undergoing activities necessary to prepare them for their intended use or sale, which are being funded out of general borrowings of the entity.

3. The submitter thinks that the Standard's requirements and the IASB's intention on such borrowings may not have been clearly explained and that this has led to differing interpretations in practice.

4. The Interpretations Committee discussed the issue in their meeting in May 2015. Our analysis of this issue was included in [Agenda Paper 9] of the Interpretations Committee meeting held in May 2015.

5. After the meeting, the *IFRIC update* reported that:

> 'The Interpretations Committee received a request to clarify whether funds borrowed specifically to finance the construction of a qualifying asset, the construction of which has now been completed, must be included as part of the general borrowings for the purposes of determining the capitalisation rate for qualifying assets that have been funded from the entity's general borrowings. The submitter described a scenario in which an entity borrows funds specifically to finance the construction of a qualifying asset. Subsequently, the activities necessary to prepare the asset for its intended use or for sale were completed, but the funds have not been repaid. The submitter notes that this is a common scenario and could arise in group situations. It could also arise in instances in which an entity wishes to maintain a specified level of borrowings for an optimal capital structure amongst others.
>
> The submitter asked whether the funds borrowed specifically to finance the construction of a qualifying asset should be included within the general borrowings after the construction of the specific asset is completed. The consequence of including these funds within the general borrowings is that the interest rate on the borrowings would be included in the calculation of the capitalisation rate to be applied to other qualifying assets that have been funded from general borrowing sources as described in paragraph 14 of IAS 23.
>
> When determining the capitalisation rate to be applied to qualifying assets that have been funded from general borrowings, paragraph 14 of IAS 23 requires an entity to use 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 purposes of obtaining a qualifying asset'. On the basis of the wording in paragraph 14 of IAS 23, a majority of the Interpretations Committee tentatively agreed with the staff conclusion that the specific borrowings should be included within the general borrowings in the fact pattern described by the submitter.
>
> However, the Interpretations Committee noted that there is diversity in practice, which arises from a perceived lack of clarity in the wording in paragraph 14 of IAS 23. The Interpretations Committee tentatively decided that the wording in IAS 23 should be clarified through an annual improvement. The staff will present the proposed improvement at a future meeting.'

6. This paper presents the staff draft of the proposed amendment to IAS 23 and provides an assessment of the proposed amendment against the annual improvements criteria.

Proposal for amendment

7. On the basis of the recommendation of the Interpretations Committee, we are proposing to amend the existing wording in paragraph 14 of IAS 23. This amendment will clarify that the calculation of the capitalisation rate to be applied to expenditures incurred on a qualifying asset that has been funded from the general borrowings of an entity should include the weighted average of all borrowing costs other than those that have already been capitalised to a qualifying asset in accordance with the requirements of paragraph 12 of IAS 23.

8. The proposed amendment is presented in Appendix A of this agenda paper.

Transition provisions

9. When the IASB introduced the requirement to capitalise borrowing costs in accordance with IAS 23 (and to remove the option to recognise borrowing costs as an expense immediately through profit or loss), the IASB decided to require prospective application for qualifying assets having a commencement date for capitalisation that

was on or after the effective date. The IASB also permitted an entity to apply the revised Standard from any designated date before the effective date, provided it applied the Standard to all qualifying assets for which the commencement date for capitalisation was on or after that designated date.

10. The rationale for the transitional provisions are described in paragraphs BC15-BC17 of IAS 23, which state:

> ‘BC15 Development of a qualifying asset may take a long time. Additionally, some assets 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.’

11. For reasons similar to those outlined above, we think that if an entity had not been transferring the specific borrowings to the general borrowings pool once the construction of that specific qualifying asset had been completed, the costs of gathering the information required to capitalise the cost of such a borrowing retrospectively and to adjust the carrying amount of the asset may exceed the potential

benefits. Accordingly, we propose that the amendments should be applied prospectively. Earlier application of the amendments should be permitted.

Consequential amendments

12. We have reviewed other IFRSs for potential consequential amendments triggered by this proposed amendment.

13. We specifically considered the requirements of paragraph D23 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* and noted that paragraph D23 of IFRS 1 permits an entity to apply the requirements of IAS 23 from the date of transition or from an earlier date as permitted by paragraph 28 of IAS 23. We do not think that the proposed amendment has an effect on this exemption from IAS 23.

14. As a result of this review, we do not propose any consequential amendments to IFRS 1 or to any other Standards.

Assessment against the criteria for annual improvements

15. We assessed the proposed amendment against the criteria for annual improvements, as shown in the following table:

Criteria for annual improvements	
An annual improvement should (6.11, 6.12): • Replace unclear wording; • Provide missing guidance; or • Correct minor unintended consequences, oversights or conflict.	**Yes.** As noted by the Interpretations Committee in its meeting in May 2015, there is a perceived lack of clarity in the wording of paragraph 14 of IAS 23. The proposed amendment clarifies when a specific borrowing should be excluded from the general borrowings pool and is consistent with the existing principles in IAS 23.

Criteria for annual improvements	
Not change an existing principle or propose a new principle	**Yes.** We think that the proposal is not changing an existing principle or proposing a new principle. Instead, we think that the proposal is clarifying existing principles in IAS 23.
Not be so fundamental that the IASB will have to meet several times to conclude (6.14)	**Yes.** We think that the proposed amendment is not so fundamental that the IASB will have to meet several times to conclude.

16. On the basis of this assessment we think the proposed amendment meets the criteria for inclusion in the *Annual Improvements Cycle 2015-2017*.

Staff recommendation

17. In the light of the results of the Interpretations Committee's discussion at its meeting in May 2015 and our assessment above, we think that the Interpretations Committee should recommend to the IASB that the amendment proposed in Appendix A of this paper should be included in the *Annual Improvements Cycle 2015-2017.*

Questions for the Interpretations Committee

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree that the proposed amendment meets the criteria for inclusion in the *Annual Improvements Cycle 2015-2017?*
2. Does the Interpretations Committee have any suggestions on the proposed wording of the proposed amendment to paragraph 14 of IAS 23?
3. Does the Interpretations Committee agree that the proposed amendment should be applied on a prospective basis?

Appendix A—Proposed amendment

Proposed Amendment to IAS 23 Borrowing Costs

Paragraph 14 has been amended. Paragraphs 28A and 29C have been added. New text is underlined and deleted text is struck through. Paragraphs 10-13 and 15 have not been amended but have been included for ease of reference.

Recognition

[...]

Borrowing costs eligible for capitalisation

10 The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

11 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. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. 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.

12 **To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.**

13 The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

14 **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 <u>costs</u> ~~made specifically for the purpose of obtaining a qualifying asset~~ <u>that are eligible for capitalisation during the period in accordance with paragraph 12.</u> 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.**

15 In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

Transition provisions

[...]

<u>28A</u> <u>*Annual Improvements 2015-2017* amended paragraph 14. An entity shall apply these amendments to borrowing costs relating to qualifying assets for which the commencement date is on or after the effective date.</u>

Effective date

[...]

<u>29C</u> <u>*Annual Improvements 2015-2017* amended paragraph 14. An entity shall apply that amendment for annual periods beginning on or after January 1, 20xx. Earlier</u>

application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.

Basis for Conclusions on the proposed amendments to IAS 23 *Borrowing Costs*

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

Borrowing costs eligible for capitalisation

BC1 The Board is proposing to clarify the requirements of paragraph 14 of IAS 23 in response to a perceived lack of clarity in the wording of this paragraph. A submission to the IFRS Interpretations Committee suggested that it is not clear whether funds borrowed specifically to finance the construction of a qualifying asset, the construction of which has now been completed, must be included as part of the general borrowings for the purposes of determining the capitalisation rate for qualifying assets that have been funded from the entity's general borrowings.

BC2 The IFRS Interpretations Committee's analysis found the existence of diversity in practice and concluded that the Board should clarify the wording in paragraph 14 of IAS 23. The proposed amendment clarifies that a borrowing made specifically to obtain a qualifying asset can only be excluded from the borrowings used to determine the capitalisation rate to be applied to other qualifying assets that have been funded from the general borrowings pool if the interest on that specific borrowing is being capitalised to a qualifying asset under the requirements of paragraph 12 of IAS 23. The wording now focuses on which borrowing costs are eligible for inclusion in the calculation of the capitalisation rate rather than the qualifying asset and the purpose of the borrowings, which was a source of the perceived ambiguity in the wording in IAS 23. The Board thinks that this clarification will remove the perceived ambiguity in the wording of IAS 23.

Effective date and transition

BC3 The Board observed that a qualifying asset may take a long time to get ready for its intended use or sale. In addition, some assets that are currently in use may have undergone and completed their production or construction process many years ago. If an entity has not been including the specific borrowings in the general borrowings pool once the construction of the associated specific qualifying asset had been completed, 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. Accordingly, the Board has decided to require prospective application of the proposed amendment.