IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

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

1. The IFRS Interpretations Committee ('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 general borrowings for the purposes of determining the capitalisation rate for other qualifying assets under IAS 23 *Borrowing Costs*.

2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and the staff's research, analysis and recommendation.

3. The submission is reproduced in full in Appendix B to this Staff Paper.

Structure of the Staff Paper

4. This paper is organised as follows:

   (a) Background information;

   (b) Summary of outreach conducted;

   (c) Staff analysis;

   (d) Assessment against the Interpretations Committee's agenda criteria;

   (e) Staff recommendation;

(f) Questions for the Interpretations Committee;

(g) Appendix A—Proposed wording for tentative agenda decision; and

(h) Appendix B—Submission.

Background information

The issue

5. IAS 23 requires an entity to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.

6. A qualifying asset is defined in paragraph 5 of IAS 23 as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'.

7. Paragraph 10-12 of IAS 23 notes that:

> '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.
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> 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.'

8. Paragraph 14 of IAS 23 notes that:

'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.'

9. The submitter describes 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.

10. The submitter is seeking clarification on whether those funds, that had been borrowed specifically to finance the construction of the qualifying asset that has been completed, should now be included in the pool of general borrowings used to determine the capitalisation rate for other qualifying assets.

11. The borrowing that was incurred specifically to finance the construction of a qualifying asset is hereafter referred to as 'specific borrowing' and the borrowings that are used to determine the capitalisation rate for other qualifying assets funded from the entity's general borrowings are hereafter referred to as the 'general borrowings pool' for ease of reference.

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

13. The submitter has identified the following two divergent views that have developed in practice:

(a) View 1—judgement is required; and

(b) View 2—the specific borrowing must be transferred to the general borrowings pool.

View 1—judgement is required

14. Proponents of this view state that management will need to exercise judgement in determining whether the borrowing costs are directly attributable to the other qualifying assets and whether or not those borrowing costs could otherwise have been avoided. They note that management will have to assess the entity's policies and the nature of the loans when construction activity is completed in order to determine whether the specific borrowing should be transferred to the general borrowings pool in the scenario described by the submitter.

15. Proponents of this view note that there could be several reasons why a company may elect to not repay a specific borrowing once the qualifying asset is ready for its intended use, such as maintaining an optimal capital structure. An entity may have significant cash reserves and still choose to maintain a certain minimum level of borrowings. They note that the Standard acknowledges (in paragraph 11) the difficulty in identifying a direct relationship between particular borrowings and a qualifying asset.

View 2—the specific borrowing must be transferred to the general borrowings pool

16. Proponents of this view note that if specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding. This is because cash is a fungible asset and if the cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, the borrowing cost would be avoided.

17. This is consistent with paragraph 10 of IAS 23, which states that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset are the borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Summary of outreach conducted

18. In order to gather information about the issue described in the submission, we sent requests to the International Forum of Accounting Standard-Setters, regulators, and global accounting firms. Specifically, we asked:

    Q1. In your jurisdiction, what is the prevalent approach for accounting for specific borrowings that are not repaid upon completion of construction of the specified asset?

    Q2. If possible, could you please describe the rationale for that approach?

    Q3. To what extent do you observe diversity in the accounting treatment in such situations?

We also asked respondents to explain the basis on which they had prepared their response. For example, if they conducted their own outreach we requested them to tell us the type of stakeholders that responded (e.g. preparers under IFRS in their jurisdictions).

19. The views received represent informal opinions and do not reflect the formal views of those organisations.

Responses from national standard-setters

20. We received 10 responses from national standard-setters. The geographical breakdown for the responses received from the national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	4
Europe	2
Americas	2
Oceania	2
Africa	0
Total respondents	**10**

21. There were mixed views from respondents on the prevalent approach within their jurisdictions.

22. Four respondents noted that both views were seen in practice and that there were mixed views on this issue within their respective jurisdictions. One of these respondents noted that while both were seen in practice, the most prevalent view within their jurisdiction was View 1.

23. One respondent noted that View 2 was applied in practice. However, that respondent acknowledged that diversity could arise, because judgement was required.

24. Four respondents noted that the issue was not common within their jurisdictions. One of these respondents noted that they thought that judgement would be

required (ie View 1) and two of these respondents thought that the specific borrowings should be transferred to the general borrowings pool (ie View 2)

Responses from regulators

25. We received responses from two organisations representing groups of regulators. The respondents indicated that the regulators had very limited practical experience with the issue, but referred back to a similar discussion by the Interpretations Committee in 2009 (details of which are noted in the staff analysis below) noting that the agenda decision mentioned that judgement is required and no further guidance needed to be provided. One response noted that some regulators felt that either view should reach the same conclusion when applying reasonable judgement, unless the 'judgement' was being used to achieve a particular outcome.

Responses from accounting networks

26. We received responses from the global IFRS groups of four accounting networks.

27. All the networks noted that there is diversity in practice and that the prevalent accounting treatment may vary by jurisdiction. One network noted that they are aware of regulators in certain territories expressing preference for specific treatments. One network believed the more prevalent accounting treatment is consistent with View 2. Another network noted that some might take the view that once a borrowing has been classified as specific, its nature does not change while it remains outstanding.

28. One network noted that the diversity arises partly because IAS 23 lacks detailed guidance in this and other areas and that the specific question raised was only one of several that arise on the detailed implementation of the Standard. Another network noted that the diversity arises because of different emphasis being placed on different paragraphs within the Standard. Another network noted that the arguments made in support of View 2 were not compelling and they thought that View 1 was supportable and that judgement should be applied.

29. One respondent pointed out that the inclusion or exclusion of the borrowing from the general borrowings pool would only have a material impact when:

    (a) the interest rate on the specific borrowing was significantly different from the weighted average interest rate of the rest of the borrowings; or

    (b) the borrowing costs added to the general pool would be eligible for capitalisation (because the amount of borrowing costs an entity capitalises during a period is limited to the amount of borrowing costs incurred during that period).

Staff analysis

The requirements of IAS 23

30. The core principle of IAS 23, as noted in paragraph 1 of the Standard, is that 'borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset…'

31. Paragraph 10 of IAS 23 notes that directly attributable costs are those that 'would have been avoided if the expenditure on the qualifying asset had not been made…'. Paragraph 11 acknowledges the difficulty in identifying a direct relationship between particular borrowings and a qualifying asset and states that 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.'

32. However, as noted previously, paragraph 14 specifically states that where general borrowings are used to obtain a qualifying asset, the capitalisation rate is 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'.

Does a borrowing made for a qualifying asset remain a specific borrowing even after the asset is ready for its intended use or sale?

33. Once an asset is ready for its intended use or sale, it no longer meets the definition of a qualifying asset under IAS 23.

34. As a result, we think that once an asset is ready for its intended use or sale, the borrowing associated with that asset (if it has not been repaid) cannot continue to qualify as a 'borrowing made specifically to obtain a qualifying asset' for the purpose of determining the capitalisation rate to be applied to other qualifying assets in accordance with the requirements of paragraph 14 of IAS 23.

35. The issue is then whether a borrowing that relates specifically to a non-qualifying asset should be excluded from the general borrowings pool in applying the methodology specified by paragraph 14 for the determination of the capitalisation rate to be applied to other qualifying assets.

36. A similar issue of whether a borrowing that relates specifically to a non-qualifying asset can be excluded from the general borrowings pool has previously been discussed by the IASB and by the Interpretations Committee.

Previous issue discussed by the IASB and the Interpretations Committee

37. Both the IASB and the Interpretations Committee previously discussed an issue concerning whether funds borrowed specifically to finance the construction of an asset other than a qualifying asset would form part of the general borrowings pool.

38. The IASB concluded that the requirements in IAS 23 were clear. The IASB update from July 2009[1] notes:

> 'IAS 23 requires an entity to determine a rate on its general borrowings for purposes of capitalising borrowing costs on qualifying assets. The issue was whether debt incurred specifically to acquire a non-qualifying asset could be excluded from general borrowings. The Board noted that IAS 23 excludes *only debt used to acquire qualifying*

[1] http://www.ifrs.org/Updates/IASB-Updates/2009/Documents/July2009IASBUpdateforweb.pdf

assets from the determination of the capitalisation rate. The Board decided not to include this issue in the annual improvements project.' (emphasis added).

39. The Interpretations Committee had also discussed this issue but had reached a conclusion that judgement was required and that any guidance provided would be in the nature of application guidance. The final agenda decision from the Interpretations Committee, published in November 2009[2], is reproduced below:

> 'The IFRIC received a request for guidance on what borrowings comprise "general borrowings" for purposes of capitalisation of borrowing costs in accordance with IAS 23. IAS 23 paragraph 14 states that "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*" (emphasis added). The request asked for guidance on the treatment of general borrowings used to purchase a specific asset other than a qualifying asset as defined in the standard.
>
> The IFRIC noted that because paragraph 14 of IAS 23 refers only to qualifying assets, some conclude that borrowings related to specific assets other than qualifying assets cannot be excluded from determining the capitalisation rate for general borrowings. Others note the general principle in paragraph 10 that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are borrowing costs that would have been avoided if the expenditure on the

[2] http://media.iasb.org/November09IFRICUpdate.html

> qualifying asset had not been made. The IFRIC noted that paragraph 11 of IAS 23 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 IFRIC noted that the standard itself acknowledges that judgement will be required in its application. In addition, the IFRIC concluded that any guidance it could provide would be in the nature of application guidance rather than an interpretation. The IFRIC also noted that the Board will consider whether to add this issue to the annual improvements project. At its meeting in July, the Board noted that IAS 23 excludes only debt used to acquire qualifying assets from the determination of the capitalisation rate. The Board decided not to include this issue in the annual improvements project.
>
> Therefore, the IFRIC decided not to add the issue to its agenda.'

Can the borrowing be excluded from the general borrowings pool?

40. The wording in paragraph 14 relating to the application of the methodology for the determination of the capitalisation rate excludes only borrowings made specifically for the purposes of obtaining a qualifying asset. To the extent that the asset no longer meets the definition of a qualifying asset, we think that, on the basis of the wording in paragraph 14, the borrowing cannot be excluded (ie View 2).

41. This is supported by paragraph BC24 of IAS 23, which, while describing the differences between IAS 23 and SFAS 34, notes that:

> SFAS 34 requires an entity to use judgement in determining the capitalisation rate to apply to the expenditures on the asset–an entity selects the borrowings that it considers appropriate to meet the objective of capitalising the interest costs incurred that otherwise could

> have been avoided. 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*.' (emphasis added)

42. While the original intention behind the wording in paragraph 14 is not clear, in our view, the exclusion in paragraph 14 appears to have been written in order to avoid double counting of borrowing costs that are being capitalised. To the extent that some borrowing costs have already been capitalised specifically to a qualifying asset, it would not then be appropriate to include those same borrowings again as part of the general borrowings pool.

43. This would imply that to the extent that interest has not been capitalised specifically to a particular asset, which would be the case in the scenario described, the entity should include the borrowings in the general pool.

Assessment against the Interpretations Committee's agenda criteria

44. We have assessed this issue against the agenda criteria of the current *Due Process Handbook*:

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	On the basis of our outreach, we understand the issue to be common and we note that there is diversity in practice in this area.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No**–we think the wording in the existing Standard provides a sufficient basis for determining the appropriate treatment.

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	Not applicable
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable

Staff recommendation

45. We think that, on the basis of the existing guidance in paragraph 14 of IAS 23, the specific borrowing should form part of the general borrowings pool in the scenario described by the submitter (ie View 2).

46. On the basis of our assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not take the issue onto its agenda.

47. See Appendix A for a draft of the tentative agenda decision.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with our analysis in this paper and our conclusion that in the scenario described by the submitter the specific borrowing should be transferred to the general borrowings pool?
2. Does the Interpretations Committee agree with the staff's recommendation not to add this issue to its agenda?
3. Does the Interpretations Committee have any comments on the proposed wording in Appendix A for the tentative agenda decision?

Appendix A—Proposed wording for tentative agenda decision

IAS 23 *Borrowing Costs*—Borrowing costs for completed qualifying assets

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 general borrowings for the purposes of determining the capitalisation rate for other 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 asked whether the funds borrowed specifically to finance the construction of a qualifying asset should be included in general borrowings after the construction of the specific asset is completed. The consequence of including these funds within 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 *Borrowing Costs*.

The Interpretations Committee noted that, in relation to the fact pattern analysed, paragraph 14 states specifically that '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 Interpretations Committee observed that IAS 23 only excludes debt used to acquire qualifying assets for the calculation of the capitalisation rate and once the activities necessary to prepare an asset for its intended use or for sale have been completed, the asset no longer meets the definition of a qualifying asset under IAS 23.

In the light of existing IFRS requirements the Interpretations Committee determined that neither an interpretation nor an amendment to a Standard was necessary and therefore [decided] not to add this issue to its agenda.

Appendix B—Submission

B1. We received the following request. We have deleted details that would identify the submitter of this request.

Request for IFRIC Agenda Item – Clarification on borrowing costs for completed qualifying assets in IAS 23 *Borrowing Costs*

The submitter is seeking clarification on the accounting treatment for borrowing costs under IAS 23 Borrowing Costs ('IAS 23 or the Standard'). The core principle of IAS 23 is that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense.

1. The Issue

The issue that we are seeking clarification is whether paragraph 14 of IAS 23 mandatorily requires funds borrowed specifically to finance the construction of qualifying asset to be included as part of general borrowings for the purpose of determining the capitalisation rate when the entity completes construction of that specific qualifying asset and the borrowing is not fully repaid.

2. The divergent views and reasons for divergence

Based on the publications issued by the major audit firms, we observe that the wordings in IAS 23 have been differently interpreted. We believe the different interpretations arose because the Standard's requirement and the IASB's intent for such borrowings may not have been clearly explained.

<u>View 1: Judgment is required</u>

Some publications state that management will need to exercise judgement in determining its policy and assessing the nature of loans when construction activity is completed, given that the Standard acknowledges the difficulty to identify a direct relationship between particular borrowings and a qualifying asset.

View 2: Specific borrowings are transferred to general borrowings pool

Some other publications state that if specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding. This is because if cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, the borrowing cost could be avoided. This is consistent with paragraph 10 of IAS 23 which states that borrowing costs are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing cost that would have been avoided if the expenditure on the qualifying asset had not been made. IAS 23 does not require the proceeds from borrowings to be matched to the qualifying assets, e.g. proceeds from working capital borrowings are considered as general borrowings and not matched to working capital. Instead, IAS 23 associates the borrowing costs incurred during the period to any qualifying assets outstanding during the same period.

3. IFRS Interpretations Committee agenda criteria evaluation

We believe this issue satisfies the IFRS Interpretations Committee agenda criteria evaluation. Please refer to **Appendix 1** for reasons for the Interpretations Committee to address the issue.

4. Additional comments

We are mindful that the IASB and the IFRIC in 2009 rejected a request to clarify what borrowings comprise "general borrowings" for purposes of capitalisation of borrowing costs. The IFRIC concluded that any guidance it could provide would be in the nature of application guidance rather than an interpretation while the IASB noted it is clear that IAS 23 excludes only debt used to acquire qualifying assets from the determination of the capitalisation rate.

Notwithstanding the IASB past decision, divergent views continue to exist based on the publications issued by the major audit firms.

We therefore urge the IFRS Interpretations Committee (or the IASB) to re-consider providing further explanation to clarify whether paragraph 14 of IAS 23 mandatorily requires funds borrowed specifically to finance the construction of qualifying asset to be included as part of general borrowings when the entity completes construction of that specific qualifying asset and the borrowing is not repaid.

Appendix 1 to submission– Reasons for the Interpretations Committee to address the issue

IFRIC evaluation criteria	Meet IFRIC criteria?	
Is the issue widespread and has, or is expected to have, a material effect on those affected?	Yes	Entities in various industries, for example manufacturing and construction, rely heavily on borrowings. In addition, it is not uncommon for entities with huge cash reserves to maintain a certain level of borrowings for an optimal capital structure to manage their cost of capital. For this reason, specific borrowings raised to fund the qualifying asset may not be repaid before maturity. In group situations, the subsidiary that raised the specific borrowings to fund a qualifying asset does not necessarily repay the borrowings when the qualifying asset is completed and has no other qualifying asset while another subsidiary within the group has qualifying assets but no borrowings. The situation is complicated when local exchange controls impose restrictions on the transfer of funds or the group does not practice pooling of funds within group entities.
Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?	Yes	While it is equally important to uphold the principle-based approach, we believe additional guidance on this issue would help to create consistent interpretations of the Standard which would improve comparability of financial statements.
Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?	Yes	We believe the issue can be efficiently resolved within the scope of IAS 23.
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations	Yes	The issue is narrow enough to be efficiently addressed. We also think the issue is not so narrow that it is not cost-effective for the IFRIC to examine given the issue is widespread.

IFRIC evaluation criteria	Meet IFRIC criteria?	
Committee to undertake the due process that would be required when making changes to IFRSs?		
Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.	Yes	There are no planned or current IASB projects that the issue relates to.