IFRS

STAFF PAPER

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IASB 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 asking whether particular borrowings should be included in the determination of the capitalisation rate to be applied to qualifying assets funded from general borrowings of an entity. The borrowings were made specifically to finance the construction of a qualifying asset and remain outstanding subsequent to completion of the construction of that qualifying asset.

2. The Interpretations Committee discussed the issue in their meetings in May 2015 and July 2015. The Interpretations Committee recommends that the IASB should address the issue through an amendment to the wording in paragraph 14 of IAS 23 *Borrowing Costs* in the form of an annual improvement.

Purpose of this paper

3. The purpose of this paper is to:

   (a) present background information on the issue;

   (b) provide a summary of the staff's analysis and the Interpretations Committee's discussions;

   (c) provide an assessment against the criteria for annual improvements; and

   (d) ask the IASB whether it agrees with the recommendation of the Interpretations Committee.

4. Appendix A provides a draft of the proposed amendment to IAS 23. This information has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

Background

5. 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 that are undergoing activities necessary to prepare them for their intended use or sale, and those activities are being funded from the entity's general borrowings.

6. The submitter asked for clarification on whether those funds, which 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.

7. 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.

8. The submitter identified the following two divergent views that have developed in practice:
   (a) View 1—judgement is required:

Proponents of this view state that management needs 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.

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 to maintain 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; and

(b) View 2—the specific borrowing shall be transferred to the general borrowings pool:

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. They argue that 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 staff analysis and Interpretations Committee's discussion

9. The following presents a summary of the staff analysis. Our full analysis of the issue can be found in Agenda Paper 9 of the Interpretations Committee meeting in

May 2015 and [Agenda Paper 7](#) of the Interpretations Committee meeting in July 2015.

10. Our outreach confirmed that the issue is widespread and that there is diversity of views and practice on this issue. We understand the issue could have a material effect on those affected, primarily in instances in which:

    (a) the interest rate on the specific borrowing is significantly different from the interest rate on other borrowings; or

    (b) the entity does not have any borrowings other than the specific borrowing.

11. 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.

12. 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.
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> 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. 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.

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

15. 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' in accordance with the requirements of paragraph 14 of IAS 23.

16. 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.

17. The wording in paragraph 14 of IAS 23 excludes only borrowings made specifically for the purposes of obtaining a qualifying asset. To the extent that the asset is no longer a qualifying asset, we think that the borrowing must be included in the determination of the capitalisation rate.

18. In our view, the exclusion in paragraph 14 was 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.

19. 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.

20. 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. See paragraphs 21-23 of this paper, which follow.

Previous issue discussed by the IASB and the Interpretations Committee

21. Both the IASB and the Interpretations Committee had 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.

22. 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

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

> excluded from general borrowings. 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. (emphasis added).

23. The Interpretations Committee had also discussed this issue, but had reached the 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

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

> would have been avoided if the expenditure on the 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.

Summary of Interpretations Committee discussions

24. On the basis of the wording in paragraph 14 of IAS 23, a majority of the Interpretations Committee members tentatively agreed with the staff's analysis and conclusion that the specific borrowings should be included within the general borrowings in the fact pattern described by the submitter.

25. However, some members of the Interpretations Committee observed that the current wording in paragraph 14 of IAS 23, which excludes 'borrowings made specifically for the purpose of obtaining a qualifying asset', could be interpreted as a reference to the historical purpose of the borrowing. They thought this might lead some to exclude the borrowing from the general borrowings pool after the construction of the specified asset has been completed.

26. The Interpretations Committee noted that the diversity in practice arises from the perceived lack of clarity in the wording of paragraph 14 of IAS 23 and

consequently decided to recommend a clarification to the wording in the form of an annual improvement.

Proposed amendment to IAS 23

27. The Interpretations Committee has proposed to amend the existing wording in paragraph 14 of IAS 23. This amendment will make it clear that the calculation of the capitalisation rate should include the weighted average of all borrowing costs, other than those that are eligible for, and have been capitalised to, a specific qualifying asset during the period.

28. The proposed amendment is presented in Appendix A of this Agenda Paper. This information has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

Transition provisions

29. 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 rationale for the transition provisions is described in paragraph BC15 of IAS 23, which states:

> ‘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. '

30. For reasons similar to those outlined above, the Interpretations Committee noted that if an entity had not included specific borrowings in the general borrowings pool after the construction of a specific qualifying asset is completed, the costs of gathering the information required to retrospectively adjust the borrowing costs capitalised may exceed the potential benefits.

31. Consequently, the Interpretations Committee recommends that the proposed amendments should be applied on a prospective basis with earlier application permitted.

Consequential amendments and first-time adopters

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

33. We noted that paragraph D23 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* already 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 further amendments to IFRS 1 are required.

34. As a result of this review, the Interpretations Committee has not proposed any consequential amendments to IFRS 1 or to any other Standards.

Assessment against the criteria for annual improvements

35. The Interpretations Committee 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.** The Interpretations Committee noted in its meeting in May 2015 that there is a lack of clarity in the wording of paragraph 14 of IAS 23. The proposed amendment would clarify when a specific borrowing should be excluded from the general borrowings pool and is consistent with the existing principles in IAS 23.
Not change an existing principle or propose a new principle	**Yes.** The Interpretations Committee noted 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.** The Interpretations Committee did not think that the proposed amendment is not so fundamental that the IASB will have to meet several times to conclude.

36. On the basis of this assessment, the Interpretations Committee concluded that the proposed amendment meets the criteria for annual improvements and has recommended that the amendment should be included in the *Annual Improvements Cycle 2015-2017*.

Questions for the IASB

Questions for the IASB
1. Does the IASB agree with the Interpretations Committee's analysis and conclusion that the specific borrowing should be transferred to the general borrowings pool once the construction of the specific qualifying asset has been completed?

2. Does the IASB agree that the proposed amendment meets the criteria for inclusion in the *Annual Improvements Cycle 2015-2017?*

3. Does the IASB agree that the proposed amendment should be applied on a prospective basis, with early application permitted?

Appendix A—Proposed amendment

A1. Appendix A provides a draft of the proposed amendment to IAS 23. This information has been included for information purposes only and the IASB will not be asked to provide comments on the wording at the meeting. Editorial comments on the draft wording, if any, should be sent to the staff outside of the meeting.

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 12, 13 and 15 have not been amended but have been included for ease of reference.

Recognition

[...]

Borrowing costs eligible for capitalisation

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. A borrowing made specifically to obtain a qualifying asset should be excluded from this calculation if the interest on that specific borrowing is eligible for capitalisation to a qualifying asset under the requirements of paragraph 12 of IAS 23 and has been capitalised to that qualifying asset 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.

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 and Effective date

[...]

29C *Annual Improvements 2015-2017* amended paragraph 14. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 20xx. Earlier application is permitted. If an entity applies the amendment for an earlier period, it shall disclose that fact.