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STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 23 *Borrowing Costs*—Expenditures on a qualifying asset**		
Paper topic	Initial Consideration		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® Update. The approval of a final Interpretation by the Board is reported in IASB® Update.

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the amount of borrowing costs eligible for capitalisation when an entity uses general borrowings to obtain a qualifying asset.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) summary of outreach;

   (c) staff analysis; and

(d) staff recommendation.

4. There are three appendices to this paper:

(a) Appendix A—proposed wording of the tentative agenda decision;

(b) Appendix B—submission; and

(c) Appendix C—calculation of borrowing costs eligible for capitalisation.

Background information

5. In the fact pattern described in the submission:

(a) an entity constructs a qualifying asset;

(b) the entity has no borrowings at the start of construction of the qualifying asset. Partway through construction, it borrows funds generally and uses them to finance the construction of the qualifying asset; and

(c) the entity incurs expenditures on the qualifying asset both before and after it incurs borrowing costs on the general borrowings.

6. Paragraph 14 of IAS 23 *Borrowing Costs* states:

> 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…

7. The submission asks whether, in determining the expenditures on which to apply the capitalisation rate, an entity includes expenditures incurred on the qualifying asset before obtaining the general borrowings.

8. The following example illustrates the fact pattern:

(a) An entity (Company A) constructs a building. The building meets the definition of a qualifying asset. The construction begins on 1 January 2016 and ends on 30 June 2017.

(b) Company A incurs the following expenditures on constructing the building:

1 January 2016: CU10

30 June 2016: CU40

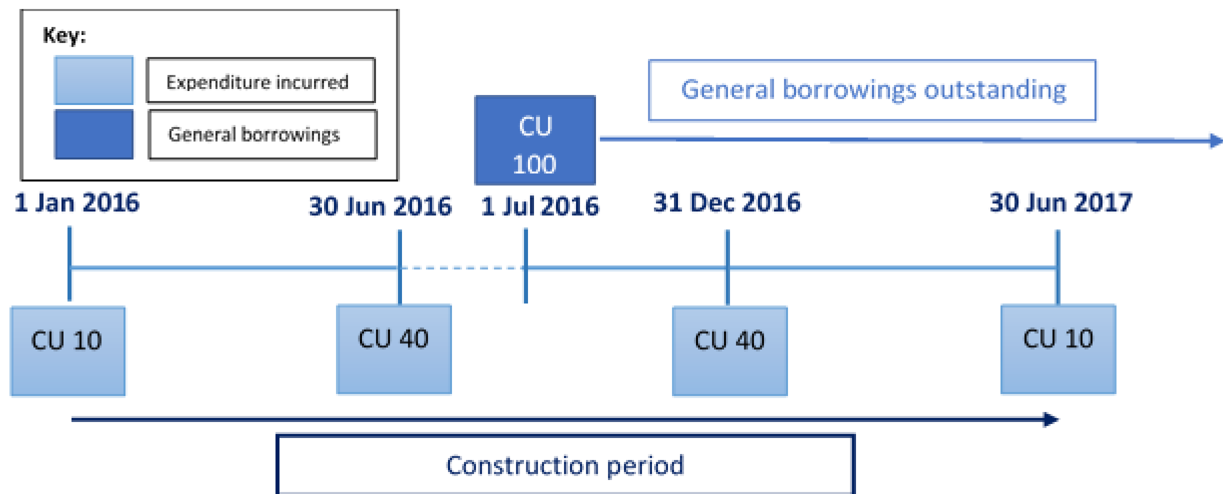
31 December 2016: CU40

30 June 2017: CU10

Total expenditure incurred CU100

(c) Company A issues bonds of CU100 on 1 July 2016. The proceeds from the bonds form part of the entity's general borrowings, which it uses to finance the construction of the qualifying asset. The entity has no borrowings (general or specific) before 1 July 2016 and does not incur any borrowing costs before that date.

(d) The following timeline illustrates when Company A incurs expenditures on the building and when it obtains general borrowings.



9. Company A incurred CU50 of expenditure before obtaining general borrowings on 1 July 2016 (pre-borrowing expenditure) and CU50 of expenditure after obtaining the general borrowings (post-borrowing expenditure). The submission asks whether, in applying paragraph 14 of IAS 23, Company A applies the capitalisation rate to:

(a) only the post-borrowing expenditure of CU50 (view 1); or

(b) the entire CU100 of expenditure incurred on the building (view 2).

10. Appendix B to this paper reproduces the submission and provides further details about the two views.

Summary of outreach

11. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators and the large accounting firms.

12. In our request we asked whether, in the participant's experience:

    (a) the situation described in the submission is common; and

    (b) if the situation is common, whether, in determining the borrowing costs eligible for capitalisation, the entity includes expenditures incurred on the qualifying asset before obtaining the general borrowings.

13. We received 15 responses—six from the large accounting firms, six from national standard-setters, two from organisations representing groups of regulators and one from an organisation representing a group of public companies from a particular jurisdiction. The views received represent informal opinions and do not represent the official views of those respondents.

Findings from outreach

Prevalence

14. A number of respondents (seven) said the fact pattern described in the submission is not common. Some of these respondents said entities would generally have some existing general borrowings, which they would use to initially finance the construction of the qualifying asset. Of the remaining respondents:

    (a) four said the situation described in the submission is common in their jurisdictions. One of these respondents said it was common for entities to experience delays in obtaining approval for financing, which could lead to the situation described in the submission;

(b) two respondents said the situation could occur in particular jurisdictions or industries; one said the amounts involved were not material due to the prevailing low interest rates in that jurisdiction; and

(c) two respondents said they had limited information about the prevalence of the scenario in practice, but said the situation could occur in practice.

Prevalence of accounting treatment

15. Many respondents said the prevalent accounting treatment applied is view 2 (ie including all expenditures—both pre and post-borrowings). Some respondents noted that, applying IAS 23, an entity would not begin capitalising costs until it incurs borrowing costs.

16. Some respondents also said:

(a) the appropriate treatment would depend on the particular facts and circumstances and could require the application of judgement.

(b) consistent with the underlying principle in IAS 23, an entity considers whether the borrowing costs are directly attributable to the qualifying asset—in other words, would the entity have avoided incurring borrowing costs if it had not constructed the qualifying asset?

Staff analysis

Applying the requirements in IAS 23

Commencement of capitalisation

17. When an entity incurs borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, it determines when it begins capitalising borrowing costs. In the fact pattern described in the submission, the entity obtains borrowings partway through the construction of the qualifying asset and has no borrowings (general or specific) before that date.

18. Paragraph 17 of IAS 23 states:

> An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:
>
> (a) it incurs expenditures for the asset;
>
> (b) it incurs borrowing costs; and
>
> (c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

19. Accordingly, an entity begins capitalising borrowing costs only after it obtains the general borrowings (ie when it starts incurring borrowing costs). In the example described in paragraph 8 of this paper, Company A would not capitalise borrowing costs before 1 July 2016 (the day it issues the bonds) even though it undertakes activities necessary to prepare the asset for its intended use or sale and incurs expenditures for the asset before that date. This is because it does not incur any borrowing costs before 1 July 2016.

Determining the borrowing costs eligible for capitalisation

20. In the fact pattern described in the submission, the entity obtains general borrowings and uses the general borrowings to construct the qualifying asset. Therefore, the entity applies paragraph 14 of IAS 23 to determine the borrowing costs eligible for capitalisation. Paragraph 14 of IAS 23 states:

> 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 all borrowings of the entity that are outstanding during the period. However, an entity shall exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities

> necessary to prepare that asset for its intended use or sale are complete. 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.

21. Paragraph 18 of IAS 23 states:

> The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

22. In the fact pattern described in the submission, the use of the 'average carrying amount' would lead to an entity including expenditures incurred both before and after obtaining general borrowings. However, the use of the word 'normally' in paragraph 18 of IAS 23 implies that an entity would not always use the average carrying amount of the asset when determining the expenditures to which the capitalisation rate is applied.

23. The general principle in IAS 23—as specified in paragraphs 8 and 10 of IAS 23—is that an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Borrowing costs that are directly attributable are those that the entity would otherwise have avoided if it had not incurred the expenditures on the qualifying asset.

24. The requirements in paragraph 14 of IAS 23 reflect this principle—paragraph 14 applies only *to the extent* the entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset. Accordingly, we think the question is not when the entity incurs the expenditure (ie before or after obtaining the general borrowings) but, rather, the extent to which it uses general borrowings for the purpose of constructing the qualifying asset.

25. In the example described in the request (see paragraph 8 of this paper), Company A borrows CU100—this represents the total expenditures on constructing the building (CU100). However, the entity incurred CU50 of expenditure on the building before it obtained the general borrowings. The fact pattern does not specify why Company A borrowed CU100 on 1 July 2016 when, at that stage, it was required to pay only an

additional CU50 to complete construction of the building. In particular, it is unclear whether Company A:

(a) uses the entire CU100 of general borrowings to finance the construction of the building; or

(b) uses only CU50 of the general borrowings (representing the post-borrowing expenditure on the building) to finance the construction of the building and uses the remaining CU50 of borrowings for another purpose.

26. In assessing whether Company A includes the entire CU100 of expenditure or includes only CU50 of expenditure when determining the borrowing costs eligible for capitalisation, we think Company A considers whether it:

(a) uses the entire borrowing of CU100 for the purpose of constructing the building or uses only CU50 for the purpose of constructing the building and uses the additional CU50 of borrowings for another purpose. This would depend on the particular facts and circumstances.

(b) would have avoided incurring borrowing costs on the entire CU100 of borrowings (or whether it would have avoided incurring borrowing costs only on CU50 of borrowings—representing the post-borrowing expenditure on the building) if it had not constructed the building.

Other Consideration—Calculation of borrowing costs eligible for capitalisation

27. Assuming that, in the example described in the submission (see paragraph 8 of this paper), Company A determines that it uses the entire CU100 of general borrowings for the purpose of constructing the building, it would determine the borrowing costs eligible for capitalisation using a methodology similar to that described in view 2 of the submission (see page 15 of this paper).

28. In the example in the submission, the entity incurs CU10 of expenditure on 1 January 2016 and obtains general borrowings on 1 July 2016. Accordingly, it cannot begin capitalising borrowing costs until 1 July 2016. However, the calculation of the borrowing costs eligible for capitalisation as shown in view 2 of the submission (see page 15 of this paper) results in the entity capitalising borrowing costs on this CU10

of expenditure for the period from 1 January 2016 to 30 June 2016. We do not agree with this calculation. Appendix C to this paper sets out our view on how Company A would determine the borrowing costs eligible for capitalisation in this situation.

Conclusion

29. Assessing whether to include expenditures on a qualifying asset before obtaining general borrowings for the purpose of determining borrowing cost eligible for capitalisation requires judgement and depends on the particular facts and circumstances. In making this assessment, the entity considers:

    (a) the extent to which it uses general borrowings for the purpose of obtaining a qualifying asset, rather than whether it incurred particular expenditures before or after obtaining the general borrowings; and

    (b) whether it could have avoided incurring the borrowings costs on the general borrowings if it had not incurred the expenditures on the qualifying asset.

    In the fact pattern described in the submission, the entity would not start capitalising borrowing costs until it obtains general borrowings and incurs borrowing costs.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IAS 23, summarised in paragraph 29 of the paper?

Should the Committee add this matter to its standard-setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

30. Based on our analysis, we think the requirements in IAS 23 provide an adequate basis for an entity to determine the borrowing costs eligible for capitalisation in the fact pattern described in the submission.

Staff recommendation

31. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 30 of this paper), we recommend the Committee does not add this matter to its standard-setting agenda. Instead, we recommend it publish an agenda decision that explains how an entity applies the requirements in IAS 23 to the fact pattern described in the submission.

32. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[1] Paragraph 5.16(b) of the *Due Process Handbook*

Appendix A—Proposed wording of the tentative agenda decision

IAS 23 Borrowing Costs – Expenditures to which a capitalisation rate is applied

The Committee received a request about the amount of borrowing costs eligible for capitalisation when an entity uses general borrowings to obtain a qualifying asset.

In the fact pattern described in the request:

(a) an entity constructs a qualifying asset;

(b) the entity has no borrowings at the start of the construction of the qualifying asset. Partway through construction, it borrows funds generally and uses them to finance the construction of the qualifying asset; and

(c) the entity incurs expenditures on the qualifying asset both before and after it incurs borrowing costs on the general borrowings.

The request asked whether an entity includes expenditures on a qualifying asset before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalisation.

The Committee observed that an entity applies paragraph 17 of IAS 23 to determine the commencement date for capitalising borrowing costs—this paragraph states that an entity begins capitalising borrowing costs when it 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.

Applying paragraph 17 of IAS 23 to the fact pattern described in the request, the entity does not begin capitalising borrowing costs until it incurs borrowing costs.

The Committee also observed the principle in IAS 23—specified in paragraphs 8 and 10 of IAS 23—that an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Borrowing costs that are directly attributable are those that the entity would otherwise have avoided if it had not incurred the expenditures on the qualifying asset. The Committee noted that the requirements in paragraph

14 of IAS 23 reflect this principle—paragraph 14 applies only to the extent the entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset.

The Committee concluded that assessing whether an entity includes expenditures on a qualifying asset before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalisation requires judgement and depends on the particular facts and circumstances. In making this assessment, an entity considers:

(a) the extent to which it uses general borrowings for the purpose of obtaining a qualifying asset, rather than whether it incurs particular expenditures before or after obtaining the general borrowings; and

(b) whether it could have avoided incurring borrowings costs on the general borrowings if it had not incurred the expenditures on the qualifying asset.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine the amount of borrowing costs eligible for capitalisation in the fact pattern described in the request. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B—Submission

A1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

1. Subject

Determination of the expenditures on the qualifying asset to which the capitalisation rate is applied in accordance with paragraphs 14 and 18 of IAS 23.

2. Background

On January 1, 2016, Company A contracted with Company X to construct a building for CU100. Company A made following payments to the construction company.

Date	2016			2017
	January 1	June 30	December 31	June 30
Amount	CU10	CU40	CU40	CU10

The construction was completed on June 30, 2017. There were no qualifying assets other than the building under construction. Company A had the following debt (general borrowing) outstanding during the reporting periods of 2016 and 2017.

3%, 3-year corporate bonds issued July 1, 2016, with interest payable annually on June 30	CU100

3. Issue

How can Company A compute the expenditures on the qualifying asset to which the capitalisation rate is applied? (Assuming the effect of capitalised borrowing costs is not material)

4. Views

a. View 1: Include only the expenditures that have incurred after the borrowing was made.

Expenditures		Capitalisation Period (Current Year)	Weighted-average accumulated expenditures
Date	**Amount**		
January 1, 2016	CU10	-	-
June 30, 2016	CU40	-	-
December 31, 2016	CU40	0/12	CU0
In 2016			**CU0**
2016	CU40	6/12	CU20
June 30, 2017	CU10	0/12	CU0
In 2017			**CU20**

Paragraph 14 of IAS 23 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."

This means that only the expenditures that incurred after the borrowing was made should be included in the weighted-average accumulated expenditures to which the capitalisation rate should be applied.

b. View 2: Include all expenditures that have incurred before and after the general borrowing was made.

Expenditures		Capitalisation Period (Current Year)	Weighted-average accumulated expenditures
Date	**Amount**		
January 1, 2016	CU10	12/12	CU10
June 30, 2016	CU40	6/12	CU20
December 31, 2016	CU40	0/12	CU0
In 2016			**CU30**
2016	CU90	6/12	CU45
June 30, 2017	CU10	0/12	CU0
In 2017			**CU45**

Paragraph 18 of IAS 23 states that "**The average carrying amount of the asset during a period** is normally a reasonable approximation of **the expenditures to which the capitalisation rate is applied** in that period."

This paragraph implies that the expenditures on a qualifying asset include all expenditures regardless of whether those expenditures incur before or after the general borrowing is made.

If View 1 is taken as the appropriate interpretation of IAS 23, there may be some problems. For example, if there were a pool of general borrowings with various commencement dates and maturities and qualifying assets with different commencement and cessation dates for capitalisation, and if there were intervals between redemption and borrowing of some general borrowings, some of the expenditures to which a capitalisation rate had been applied should be excluded from future capitalization.

5. Reasons for the IFRS IC to address the issue:

a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. There is no specific guidance on this issue in IAS 23 and therefore two different views exist on the accounting treatments under IAS 23.

b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. The comparability of financial statements would be improved if entities can apply a specific guideline.

c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

Yes. It can be resolved efficiently as it concerns the interpretation of paragraphs 14 and 18 of IAS 23.

d) 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 Committee to undertake the due process?

Yes. It is concerned only with the interpretation of paragraphs 14 and 18 of IAS 23.

e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

Yes. The issue does not relate to a current or planned IASB project.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee's agenda.

Appendix C—Calculation of borrowing costs eligible for capitalisation

A2. The following tables outline our view on how Company A calculates borrowing costs eligible for capitalisation. This calculation assumes that:

a. Company A uses CU100 of general borrowings for the purpose of constructing the building; and

b. a capitalisation rate of 3% is applied.

A. 2016 Financial Year

Expenditures		Capitalisation	Weighted-average
Date	**Amount**	**Period (Current Year)**	**Accumulated Expenditures**
1 January 2016	CU10	$\frac{6}{12}$	CU5*
30 June 2016	CU40	$\frac{6}{12}$	CU20
31 December 2016	CU40	$\frac{0}{12}$	CU0
		Total 2016 Weighted Average	**CU25**

Borrowing Costs eligible for capitalisation = CU25 × 3%= CU0.75

B. 2017 Financial Year

Expenditures		Capitalisation Period (Current Year)	Weighted-average Accumulated Expenditures
Date	Amount		
2016 Total Expenditure	CU90	$\frac{6}{12}$	CU45
30 June 2017	CU10	$\frac{0}{12}$	CU0
		Total 2017 Weighted Average	**CU45**

Borrowing Costs eligible for capitalisation = CU45 × 3%= CU1.3

* The calculation in View 2 of the submission (see page 15 of this paper) determines the weighted average accumulated expenditure as CU10—however, as discussed in paragraph 19 of this paper, the entity cannot capitalise borrowing costs before 1 July 2016 (the day it starts to incur borrowing costs). Accordingly, this calculation uses a capitalisation period from 1 July 2016–1 December 2016 for this expenditure.