STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 23 *Borrowing Costs*—Borrowing costs on land**
Paper topic	Initial Consideration

CONTACT(S) Nicolette Lange nlange@ifrs.org +44 (0) 20 7246 6924

Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about when to cease capitalising borrowing costs on land for a particular fact pattern.

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 two appendices to this paper:

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

   (b) Appendix B—submission.

Background Information:

5. In the fact pattern described in the submission:

   (a) an entity acquires and develops land and thereafter constructs a building on that land (development project)—the land represents the area on which the building will be constructed;

   (b) both the land and the building meet the definition of a qualifying asset; and

   (c) the entity uses general borrowings to fund the development project.

6. Paragraph 22 of IAS 23 *Borrowing Costs* requires an entity to cease capitalising borrowing costs when 'substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.'

7. The submission asks whether the entity:

   (a) *ceases to capitalise borrowing costs in respect of expenditures incurred in developing the land (land development expenditures) once it begins constructing the building on the land (View 1)*

   Proponents of this view say the land's intended use is to construct a building on the land, and the land is therefore ready for its intended use when the entity completes the development of the land and begins constructing the building.

   (b) *continues to capitalise borrowing costs in respect of the land development expenditures while it constructs the building (View 2)*

   Proponents of this view say:

   (i) the borrowing costs incurred on land development expenditures while constructing the building are directly attributable to bringing the building to the location and condition necessary for it to be capable of operating in the manner intended by management; and

(ii) the land can only be used together with the building—accordingly, the land is not ready for its intended use or sale until the entity completes the development of both the land and the building.

8. Appendix B to this paper reproduces the submission and provides further details on these two views.

Summary of outreach

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

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

(a) the fact pattern described in the submission is common; and

(b) if the fact pattern is common, whether entities cease capitalising borrowing costs on land development expenditures when they start constructing the building.

11. 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

12. Some respondents (seven) said the fact pattern described in the submission is common. Other respondents said they had limited information about the prevalence of the fact pattern or that it did not occur frequently in their respective jurisdictions. Some respondents said the fact pattern was more prevalent, or could occur, in particular countries, regions or industries such as the real estate development industry.

One respondent said the amounts involved were not material due to the prevailing low interest rates in its jurisdiction.

Accounting treatment observed

13. The majority of respondents said the prevalent accounting treatment applied is View 2 (ie entities continue to capitalise borrowing costs incurred on land development expenditures while constructing the building). One respondent said entities in its jurisdiction apply either View 1 or View 2—the appropriate treatment would depend on the particular facts and circumstances.

14. Some respondents also said 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 had it not constructed the qualifying asset?

15. Some respondents also said the assessment could depend on:

    (a) whether the entity recognises the land and building separately or as one asset; and

    (b) if the entity is developing the land and building for sale, whether, applying IFRS 15 *Revenue from Contracts with Customers*, the entity:

        (i) identifies one or two performance obligations; and

        (ii) recognises revenue over time or at a point in time.

Staff Analysis

16. In order to determine when an entity ceases to capitalise borrowing costs on land development expenditures, we analysed:

    (a) the intended use of the land; and

    (b) when the entity completes substantially all the activities necessary to prepare the land for its intended use or sale.

The intended use of land

17. The submission does not explicitly specify the entity's intended use of the land and building after development. An entity generally holds land and buildings for:

    (a) owner-occupation (recognised as property, plant and equipment (PPE) applying IAS 16 *Property, Plant and Equipment*);

    (b) rent or capital appreciation[1] (recognised as investment property applying IAS 40 *Investment Property*); or

    (c) sale (recognised as inventory applying IAS 2 *Inventories*)[2].

18. Paragraphs 57–65 of IAS 40 specify how an entity accounts for transfers of property to, or from, investment property. These paragraphs confirm our view that an entity recognises property (ie land or buildings) as either investment property, owner-occupied property (PPE) or inventory, depending on its use of the property. For example, paragraph 59 of IAS 40 states '…transfers between investment property, owner-occupied property and inventories…'. These paragraphs do not identify other uses for property.

19. Accordingly, we think the intended use of the land is not simply to construct a building on the land but rather to use it for either owner-occupation, rent or capital appreciation, or sale.

When does the entity complete substantially all the activities necessary to prepare the land for its intended use or sale?

20. In this section, we assess when the entity completes substantially all the activities necessary to prepare the land for its intended use or sale.

[1] Paragraph 8(b) of IAS 40 states that land held for a currently undetermined future use is regarded as held for capital appreciation.

[2] We have assessed later in the paper the implications of different patterns of revenue recognition (ie over time or at a point in time)

21. Paragraph 22 of IAS 23 specifies when an entity ceases capitalising borrowing costs. It states:

> An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

22. Paragraph 22 of IAS 23 refers to a qualifying asset. Paragraph 5 of IAS 23 defines a qualifying asset as:

> an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

23. In addition, paragraph 24 of IAS 23 expands on the principle in paragraph 22 and states:

> When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

24. Paragraph 25 of IAS 23 illustrates the application of paragraph 24, and specifies:

> A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes, which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

25. These paragraphs clarify that in assessing when to cease capitalising borrowing costs an entity considers parts of a qualifying asset separately if each part is capable of being used while construction continues on other parts. Similarly, the entity considers a qualifying asset as one asset if that qualifying asset must be complete before the entity can use any part of it.

26. In the fact pattern described in the submission, the entity would intend to use the land for one of the three purposes described in paragraph 17 of this paper (ie owner-occupation, rent or capital appreciation, or sale). If the land is not capable of being used for that purpose while construction continues on the building, we think the entity considers the land and building together in assessing when to cease capitalising borrowing costs on the land development expenditures. In this situation, we think the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and building for that intended use or sale are complete.

Other considerations

Consistency with paragraph 19 of IAS 23

27. Paragraph 19 of IAS 23 states '…borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation'. Some might say continuing to capitalise borrowing costs on land development expenditures after completing development of the land would be inconsistent with this paragraph.

28. We do not agree—in our view, if the land is not capable of being used while construction continues on the building, then the construction of the building represents an associated development activity as referred to in paragraph 19 of IAS 23. Accordingly, in that situation, an entity would continue to capitalise borrowing costs incurred on land development expenditures while constructing the building. Our view is also consistent with the example in paragraph 25 of IAS 23 of the industrial plant involving several processes (see paragraph 24 of this paper). In that example, the entity does not cease capitalising borrowing costs on any part of the plant until the entire plant is complete.

Unit of account

29. Some respondents to our outreach request said the assessment of when an entity ceases to capitalise borrowing costs on land development expenditures could depend on whether the entity recognises the land and building separately or as one asset (see paragraph 15(a) of this paper). As discussed in our analysis (see paragraphs 20–26 of

this paper), applying IAS 23, an entity would consider the land and building together if the land is not capable of being used while construction continues on the building—this is the case regardless of whether the entity recognised the land and building separately or as one asset.

IFRS 15

30. As noted in paragraph 15(b) of this paper, some respondents to our outreach said if an entity develops the land and building for sale, the assessment of when it ceases capitalising borrowing costs incurred on land development expenditures could depend on whether, applying IFRS 15, the entity:

    (a) identifies one or two performance obligations; and

    (b) recognises revenue over time or at a point in time.

31. Applying IFRS 15, an entity recognises revenue when (or as) it satisfies a performance obligation. Accordingly, the identification of performance obligations could affect the pattern of revenue recognition (ie over time or at a point in time). As discussed below in paragraph 32 of this paper, this could affect whether an entity has a qualifying asset. However, we think the identification of performance obligations applying IFRS 15 does not otherwise affect when an entity ceases capitalising borrowing costs on a qualifying asset.

32. Applying IFRS 15, an entity recognises revenue over time or at a point in time depending on whether it transfers control of a good or service and, therefore, satisfies a performance obligation over time or at a point in time. This assessment could affect whether an entity holds inventory that meets the definition of a qualifying asset in IAS 23, and thus indirectly could affect whether and for how long the entity capitalises borrowing costs incurred on related expenditures. However, again, we think the recognition of revenue over time or at a point in time has no direct effect on when an entity ceases capitalising borrowing costs on a qualifying asset.

Conclusion

33. In determining when to cease capitalising borrowing costs on land development expenditures, the entity assesses:

    (a) the intended use of the land; and

    (b) when the entity completes substantially all the activities necessary to prepare the land for its intended use or sale.

34. An entity uses land and buildings for owner-occupation (recognised as PPE applying IAS 16), rent or capital appreciation (recognised as investment property applying IAS 40), or sale (recognised as inventory applying IAS 2). We think the intended use of the land is not simply to construct a building on the land, but rather to use it for one of these three purposes.

35. Applying paragraph 24 of IAS 23, an entity considers whether the land is capable of being used for that intended purpose while construction continues on the building. If the land is not capable of being used for its intended purpose while construction continues on the building, the entity considers the land and building together in assessing when to cease capitalising borrowing costs on the land development expenditures. In this situation, we think the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and the building for that intended use or sale are complete.

Question 1 for the Committee
Does the Committee agree with our analysis of the requirements in IFRS Standards, summarised in paragraphs 16–36 of this 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?[3]

36. Based on our analysis, we think the requirements in IAS 23 provide an adequate basis for an entity to determine when to cease capitalising borrowing costs on land development expenditures in the fact pattern described in the submission.

Staff recommendation

37. 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 37 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.

38. 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?

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

Appendix A –– Proposed wording of the tentative agenda decision

IAS 23 Borrowing Costs – Borrowing costs on land

The Committee received a request about when to cease capitalising borrowing costs on land.

In the fact pattern described in the request:

(a) an entity acquires and develops land and thereafter constructs a building on that land—the land represents the area on which the building will be constructed;

(b) both the land and the building meet the definition of a qualifying asset; and

(c) the entity uses general borrowings to fund the development of the land and construction of the building.

The request asked whether the entity ceases capitalising borrowing costs incurred in respect of expenditures on developing the land (land development expenditures) once it starts constructing the building or whether it continues to capitalise borrowing costs incurred in respect of land development expenditures while it constructs the building.

The Committee observed that in applying IAS 23 to determine when to cease capitalising borrowing costs incurred on land development expenditures:

(a) an entity considers the intended use of the land. Land and buildings are used for owner-occupation (recognised as property, plant and equipment applying IAS 16 *Property, Plant and Equipment*), rent or capital appreciation (recognised as investment property applying IAS 40 *Investment Property*), or sale (recognised as inventory applying IAS 2 *Inventories*). The intended use of the land is not simply for the construction of a building on the land, but rather to use it for one of these three purposes.

(b) applying paragraph 24 of IAS 23, an entity considers whether the land is capable of being used for that intended purpose while construction continues on the building. If the land is not capable of being used for its intended purpose while construction continues on the building, the entity considers the land and building together in assessing when to cease capitalising borrowing costs on the land development expenditures. In this situation, the land would not be ready for its intended use or sale until substantially all the activities necessary to prepare both the land and building for that intended use or sale are complete.

The Committee concluded that the principles and requirements in IFRS Standards provide an adequate basis for an entity to determine when to cease capitalising borrowing costs on land development expenditures. 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.

Borrowing costs on expenditures for land

1. Subject

Accounting treatment for borrowing costs on land expenditures after completion of the development.

2. Background

On January 1, 2015, Company B purchased land. Development activities were undertaken to make it available for building for one year. From January 1, 2016 to June 30, 2017, a building was constructed on the land. Company B[4] made following payments for the land and construction.

<Expenditures on land>

Date	**2015**		
	January 1	July 1	December 31
Amount	CU10	CU30	CU10

<Expenditures on construction>

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

[4] The original submission said 'Company A made the following payments…'. We confirmed with the submitter that this sentence should refer to Company B and not to Company A and have updated the submission accordingly.

There were no qualifying assets other than the land and the building under construction. Company B had the following debt (general borrowing) outstanding during the reporting periods of 2016 and 2017.

3%, 3-year corporate bonds issued December 31, 2014, with interest payable annually on December 31	CU150

3. Issue

Can Company B capitalise the borrowing costs on CU50 (amount equivalent to the land expenditures) during the period of construction?

4. Views

a. View 1: The borrowing costs on CU50 cannot be included in the costs of an asset.

According to paragraph 22 of IAS 23, an entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

When Company B can use the land on construction after the land development, it must cease capitalising borrowing costs on expenditures to acquire the land because substantially all the activities necessary to prepare the land for its intended use are complete.

b. View 2: The borrowing costs on CU50 should be included in the costs of the building.

When an entity purchases land and constructs a building on the land, borrowing costs of the land expenditures after completion of the land developments are regarded as costs directly attributable to bringing the building to the location and condition necessary for it to be capable of operating in the manner intended by management. As a result, these borrowing costs should be included in the cost of the building in accordance with paragraph 16 of IAS 16.

5. **<u>Reasons for the IFRS IC to address the issue</u>:**

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

Yes. In the case of this issue, many entities [in our jurisdiction] apply US GAAP*[1] (835-20-15-8). However, there are concerns that the accounting under US GAAP (View 2) may not be an appropriate interpretation for IFRS.

***[1]** 835-20-15-8: Land that is not undergoing activities necessary to get it ready for its intended use is not a qualifying asset. If activities are undertaken for the purpose of developing land for a particular use, the expenditures to acquire the land qualify for interest capitalization while those activities are in progress. The interest cost capitalized on those expenditures is a cost of acquiring the asset that results from those activities. <u>If the resulting asset is a structure, such as a plant or a shopping center, interest capitalized on the land expenditures is part of the acquisition cost of the structure.</u> <u>If the resulting asset is developed land, such as land that is to be sold as developed lots, interest capitalized on the land expenditures is part of the acquisition cost of the developed land.</u>

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

Yes. Without resolution of the issue, paragraph 22 of IAS 23 and paragraph 16 of IAS 16 may be interpreted differently not only in our jurisdiction but also in other jurisdictions.

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 paragraph 22 of IAS 23 and paragraph 16 of IAS 16.

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 only concerned with the interpretation of paragraph 22 of IAS 23 and paragraph 16 of IAS 16.

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.