

# IFRS News

Emerging issues and practical guidance\*

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## IAS 23R – Q&As



The main difference between IAS 23 and IAS 23R 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 under IAS 23R. Under the previous IAS 23, IFRS preparers could either elect to capitalise such borrowing costs or to expense them. IFRS preparers who were expensing borrowing costs under IAS 23 are in the process of adopting IAS 23R. Many questions are arising. Olivier Scherer, partner in PwC's Global Accounting Consulting Services, looks at some of the issues that Global ACS has addressed.

IFRS 23R is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted.

### General, scope and definitions

**A qualifying asset is an asset that 'necessarily takes a substantial period of time to get ready for its intended use or sale'. Is there any bright line for determining the 'substantial period of time'?**

No. IAS 23R does not define 'substantial period of time'. Management exercises judgement when determining which assets are qualifying assets, taking into account the nature of the asset. An asset that normally takes more than a year to be ready for use will usually be a qualifying asset. Once management chooses the criteria and type of assets, it applies this consistently to those types of asset.

Management discloses in the notes to the financial statements, when relevant, how the assessment was performed, which criteria were considered and which types of asset are subject to capitalisation of borrowing costs.

**Can borrowing costs incurred to finance the production of inventories that has a long production period, like wine or cheese, be capitalised?**

Yes. IAS 23R does not mandate the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis but allows it as long as the production cycle takes a 'substantial period of time', as with wine or cheese. The choice to capitalise borrowing costs on those inventories is an accounting policy choice; management discloses it when material.

### Borrowing costs eligible for capitalisation

**An entity has no borrowings and uses its own cash resources to finance the construction of property, plant and equipment. Cash being used to finance the construction could otherwise have been used to earn interest. Can management**

**capitalise a ‘notional’ borrowing cost representing the opportunity cost of the cash employed in financing the asset’s construction?**

No. A ‘notional’ borrowing cost cannot be capitalised. IAS 23R limits the amount that can be capitalised to the actual borrowing costs incurred. The standard states that it does not address actual or imputed cost of equity.

**Is interest on a finance lease of a qualifying asset capitalised as borrowing costs?**

Yes. Interest incurred for a finance lease is specific to an asset. Interest is capitalised if the asset is a qualifying asset or is used solely for the construction of a qualifying asset. For example, a crane or a dockyard is leased for the purpose of constructing a ship. The ship is a qualifying asset. The interest on the finance lease of the crane or dockyard is capitalised as borrowing costs. Borrowing costs on the finance lease can only be capitalised up to the point when the construction of the qualifying asset is complete.

**The entity uses general borrowings to finance its qualifying assets. However, cash flows from the operating activities would be sufficient to finance the capital expenditures incurred during the period. Can management claim that the general borrowings are used to finance working capital and other transactions (for example, merger and acquisition activity, finance leases) but not to finance the qualifying assets, in which case no borrowing costs would be capitalised?**

No. It is presumed that any general borrowings in the first instance are used to finance the qualifying assets (after any funds specific to a qualifying asset). This is the case even where the cash flows from operating activities are sufficient to finance the capital expenditures.

It may be appropriate, in some limited circumstances, to exclude some general borrowings from the calculation of the borrowing rate to the extent it does not result in a capitalisation rate of nil.

**A subsidiary obtained an interest-free loan from its parent and used it for the construction of a qualifying asset. Is the accretion of interest capitalised as borrowing costs in the subsidiary’s separate financial statements?**

Yes. The interest calculated using the effective interest method is an element of borrowing costs that is considered for the capitalisation.

IAS 39 requires initial recognition of the liability at fair value. The subsidiary has an accounting policy choice regarding how to account for the difference between the fair value of the loan and the amount of funds received from the parent. This difference may be treated as either an addition to the subsidiary’s equity or as income in the income statement. This should reflect

the economic substance of the transaction. When treated as income, the gain does not represent a reduction of borrowing costs.

The liability is subsequently measured at amortised cost, with interest accrued using the effective interest rate method. The interest determined using the effective interest method is an element of the borrowing costs and is considered for determining the costs eligible for capitalisation.

**When the construction of a qualifying asset is performed by a third party, are borrowing costs capitalised on the prepayments made to the third party for the acquisition of the asset?**

Yes. The borrowing costs incurred by an entity to finance prepayments on a qualifying asset are capitalised on the same basis as the borrowing costs incurred on assets constructed by the entity.

The capitalisation starts when all three conditions are met: expenditures are incurred, borrowing costs are incurred, and the activities necessary to prepare the asset for its intended use or sale are in progress.

Expenditures on the asset are incurred when the prepayments are made (payments of the instalments). Borrowing costs are incurred when borrowing is obtained. The last condition – the activities necessary to prepare the asset for its intended use or sale are in progress – is considered to be met when the manufacturer has started the construction process. Determining whether the construction is in progress requires management to obtain information directly from the manufacturer. Management should not assume that those activities start when the first instalment is paid. See Example 1 on page 3.

### Foreign exchange differences

**How should management determine the amount of foreign exchange differences to be capitalised?**

IAS 23R requires capitalisation of foreign exchange differences relating to borrowings to the extent that they are regarded as an adjustment to interest costs. The gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency, and borrowing costs actually incurred on foreign currency borrowings. Other differences that are not adjustments to interest costs may include, for example, increases or decreases in the foreign currency rates as a result of changes in other economic indicators, such as employment or productivity, or a change in government.

IAS 23R does not prescribe which method should be used to estimate the amount of foreign exchange differences that may be included in borrowing costs.

**Example 1**

In March 2007, Company A ordered four aircraft from a manufacturer for delivery in the period 2010-2014. There is a down-payment for each aircraft upon signing the contract. The remaining payment schedule for each aircraft varies based on expected delivery date for the individual aircraft. Company A funds all payments with bank borrowings.

The manufacturer starts the production planning for the first aircraft, including ordering parts from suppliers, soon after the agreement was signed. The physical assembly of the plane itself takes place within the last six months prior to delivery; however, the production of the individual parts (either at manufacturer's factories or at sub-suppliers) takes place up to 24 months before delivery.

Company A received information from the manufacturer that the production of the parts for the first planes started in February 2008. No action has yet been undertaken by the manufacturer for the production of the other three aircrafts.

Company A designated 1 January 2008 for the early adoption of IAS 23R.

Can the borrowing costs incurred by the Company A be capitalised? If so, when does capitalisation start?

**Solution**

The aircraft is a qualifying asset, as its construction takes substantial period of time to complete. The borrowing costs incurred by company A are therefore capitalised.

Company A incurs expenditures on the aircraft by making a prepayment. It also incurs the borrowing cost as the bank borrowing was obtained.

Capitalisation of the borrowing costs starts when the manufacturer starts the construction activity. The construction activity (production of parts) started in February 2008, but only in relation to one aircraft. The borrowing costs incurred in relation to this one aircraft can therefore be capitalised from February 2008. The borrowing costs incurred on the prepayments made in relation to the remaining three aircraft are expensed until the construction process begins.

The following two methods were considered by the IFRIC staff in recent discussions:

- The portion of the foreign exchange movement may be estimated based on forward currency rates at the inception of the loan; and
- The portion of the foreign exchange movement may be estimated based on interest rates on similar borrowings in the entity's functional currency.

Other methods might be possible. Management uses judgement to assess which foreign exchange differences can be capitalised. The method used to determine the amount that is an adjustment to borrowing costs is an accounting policy choice. The method is applied consistently to foreign exchange differences whether they are gains or losses.

**Cessation of capitalisation****When does capitalisation cease if the construction is completed in phases and each phase can be operated separately?**

Capitalisation for one given phase ceases when this phase is ready for its intended use or sale. Each subsequent phase will give rise to capitalisation of borrowing costs over its own construction period.

**Interaction between IAS 23 and IAS 11****An entity incurs borrowing costs for the construction of an asset accounted for under IAS 11. Does management treat the borrowing costs as a contract cost under IAS 11?**

Yes. Borrowing costs that are directly attributable to the construction of an asset are treated as contract costs in accordance with IAS 23 and IAS 11.

**Does management take into account payments received in advance from customers when determining the amount of borrowing costs to be included in contract costs?**

Yes, if an entity finances the construction contract with the general borrowings. The determination of the amount of general borrowing costs to be capitalised in the financial statements of the constructor are based on the net position of the contract, after taking into account any customer payments in respect of the contract.

The prepayments are not taken into account if an entity finances the construction with specific borrowings. Borrowing costs to be included in the cost of the contract are the actual borrowing costs incurred on that specific borrowing during the period, less any investment income on the temporary investment of those borrowings.

**Transition, first-time adoption and US GAAP differences****Does IAS 23R apply to qualifying assets existing at the transition date?**

No. IAS 23R applies to qualifying assets for which the commencement date for capitalisation is on or after the effective date. IAS 23R does not affect qualifying assets for which the commencement date for capitalisation is earlier than the transition date. However, management can decide to designate any date before the effective date and apply IAS 23R to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

- it incurs expenditures for the asset;

- it incurs borrowing costs; and
- it undertakes activities that are necessary to prepare the asset for its intended use or sale.

See Example 2.

**When reporting under US GAAP, a foreign private issuer (FPI) was capitalising interest expense in accordance with FAS 34. The FPI no longer discloses a US GAAP/IFRS reconciliation in its financial statements. Can management use the same methodology as the one used under US GAAP to report under IFRS?**

No. IAS 23R is a converged standard but some aspects of measurement still differ from FAS 34. The main theoretical differences are presented in IAS 23R BC19-26.

#### Example 2

A company decides to designate 1 January 2008 as the date from which borrowing costs will be capitalised.

The borrowings were obtained at the same time when the construction of the qualifying assets A and B started; the capitalisation criteria for both assets (A and B) were therefore first met when the construction started.

#### Solution

Borrowing costs will be capitalised for qualifying asset B but not capitalised for qualifying asset A. The capitalisation criteria for asset A were met before 1 January 2008.

See timeline below.

#### Timeline for Example 2

