IFRS News

Emerging issues and practical guidance*

Supplement – September 2008

IAS 23R – Q&As, part 2

This is the second in a series of two supplements providing Q&As on IAS 23R. Olivier Scherer, partner in Global ACS, looks at some of the issues arising from the application of the revised standard that PwC's Global Accounting Consulting Services has addressed.

IFRS 23R is effective for annual periods beginning on or after 1 January 2009 (in the EU, subject to EU endorsement). Earlier application is permitted.

General scope and definitions

The IASB has amended the list of costs that can be included in borrowing costs, as part of its 2008 minor improvement project. Will this change anything in practice?

The amendment should eliminate inconsistencies between interest expense as calculated under IAS 23R and IAS 39. IAS 23R refers to the effective interest rate method as described in IAS 39. The calculation includes fees, transaction costs and amortisation of discounts or premiums relating to borrowings. These components were already included in IAS 23. However, IAS 23 also referred to 'ancillary costs' and did not define this term. This could have resulted in a different calculation of interest expense than under IAS 39. No significant impact is expected from this change. Alignment of the definitions means that management only uses one method to calculate interest expense.

Can an intangible asset be a 'qualifying asset' under IAS 23R?

Yes. An intangible asset that takes a substantial period of time to get ready for its intended use or sale is a 'qualifying asset'. This would be the case for an internally generated intangible asset in the development phase when it takes a 'substantial period of time' to complete, such as software. The interest capitalisation rate is applied only to costs that themselves have been capitalised.

Should management's intention be taken into account to assess the 'substantial period of time to get ready for its intended use or sale'?

Yes. When an asset is acquired, management should assess whether, at the date of acquisition, it is 'ready for its intended use or sale'. Depending on how management intends to use the asset, it may be a qualifying asset under IAS 23R.

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For example, when an acquired asset can only be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one specific qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

Example

A telecom company has acquired a 3G licence. The licence could be sold or licensed to a third party. However, management intends to use it to operate a wireless network. Development of the network starts when the licence is acquired.

Should borrowing costs on the acquisition of the 3G licence be capitalised until the network is ready for its intended use?

Solution

Yes. The licence has been exclusively acquired to operate the wireless network. The fact that the licence can be used or licenced to a third party is irrelevant. The acquisition of the licence is the first step in a wider investment project (developing the network). It is part of the network investment, which meets the definition of a qualifying asset under IAS 23R.

Example

A real estate company has incurred expenses for the acquisition of a permit allowing the construction of a building. It has also acquired equipment that will be used for the construction of various buildings.

Can borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete?

Solution

Yes for the permit, which is specific to one building. It is the first step in a wider investment project. It is part of the construction cost of the building, which meets the definition of a qualifying asset.

No for the equipment, which will be used for other construction projects. It is ready for its ‘intended use’ at the acquisition date. It does not meet the definition of a qualifying asset.

In a service concession arrangement, should an operator capitalise borrowing costs incurred when constructing or upgrading an infrastructure asset?

Service concession arrangements are accounted for under IFRIC 12. The consideration received in exchange for the construction or upgrade services is recognised at its fair value either as a financial asset or an intangible asset depending on the terms of the agreement.

An operator that recognises an intangible asset in exchange for the construction capitalises the associated borrowing costs incurred during the construction phase. However, an operator that recognises a financial asset expenses the associated borrowing costs as incurred.

Property under construction or development for future use as an investment property is in the scope of amended IAS 40 (May 2008) and should be measured at fair value also during the construction period, if fair value is the accounting policy of the entity for investment property. Can borrowing costs attributable to investment property measured at fair value be capitalised?

Yes. IAS 23R does not mandate the capitalisation of borrowing costs for assets measured at fair value as, on a net basis, the measurement of the asset would not be affected. But management can still elect to capitalise those borrowing costs. An entity that elects to do so reduces its interest expense incurred during the period by the amount of borrowing costs capitalised and adjusts the carrying amount of the investment property accordingly. Re-measurement of the investment property to fair value has a direct effect on the gain or loss arising from a change in the fair value of investment property recorded in profit or loss for the period.

Borrowing costs eligible for capitalisation

A subsidiary (or jointly controlled entity or associate) finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

Yes. Borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary (or jointly controlled entity or associate).

A subsidiary (or jointly controlled entity or associate) finances a qualifying asset through a capital increase, which is provided by the parent company (or venturer or investor). Can a notional amount of borrowing costs be capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

No, as the subsidiary (or jointly controlled entity or associate) has not incurred any borrowing costs. The standard does not deal with actual or imputed cost of equity.

	Stand-alone financial statements	Consolidated financial statements		
	Cost or fair value	Full consolidation	Proportionate consolidation	Equity method
Subsidiary	No [1]	Yes [2]	n/a	n/a
Jointly controlled entity	No [1]	n/a	Yes [3]	No [4]
Associate	No [1]	n/a	n/a	No [4]

Assume the same fact patterns as in the previous question. However, the parent company (or venturer or investor) finances the inter-company loan or capital increase with a bank loan. How is this treated in the various financial statements of the parent and subsidiary (or associate or jointly controlled entity)?

1. In stand-alone financial statements, the investor (or venturer or parent) recognises only the investment in associate (or jointly controlled entity or subsidiary). This is not a qualifying asset, so the borrowing costs cannot be capitalised.

2. Capitalisation of borrowing costs is required. However, the amount of the borrowing costs incurred by the subsidiary might be adjusted to reflect how the qualifying asset was financed from the perspective of the group as a whole:
   - If the group uses external general borrowings, the borrowing costs capitalised by the subsidiary are adjusted if the capitalisation rate at the group level is different from the rate used by the subsidiary.
   - If the group uses specific external borrowings, the borrowing costs are adjusted if the borrowing costs on the external borrowings vary from the amount of borrowings costs capitalised by a subsidiary.

   Borrowing costs calculated and capitalised in accordance with IAS 23R cannot exceed the amount of borrowing costs incurred at the group level.

   If the parent company does not have any external borrowings, the borrowing costs capitalised by the subsidiary are eliminated, as there are no borrowing costs incurred from the perspective of the group.

3. When the proportionate consolidation method is applied to account for jointly controlled entities, the qualifying asset of the jointly controlled entity will meet the definition of IAS 23 in the financial statements of the venturer. The borrowing costs eligible for capitalisation are therefore determined taking into account the interests incurred for the bank loan if specific or, if not, the capitalisation rate of the general borrowings including the bank loan.

4. The only asset recognised in the financial statements of an investor that uses the equity method is the investment in associate or jointly controlled entity. Neither is a qualifying asset as defined in IAS 23R. The borrowing costs cannot therefore be capitalised.

An entity has investment income on general borrowings. Does management deduct investment income from the borrowing costs available for capitalisation?

No. No specific guidance is given about general borrowings, unlike specific borrowings (borrowing costs less investment income). The funds invested 'temporarily' cannot be considered to be those from the general borrowings rather than from other sources (equity or cash generated from operating activities). It cannot therefore be demonstrated that the income is earned from the general borrowings.

How is the amount of borrowing costs eligible for capitalisation determined when a qualifying asset is financed by a combination of borrowings that are specific to the asset and by general borrowings?

The amount of borrowing costs eligible for capitalisation is calculated in the following way:

- To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, management determines 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 (IAS 23R paragraph 12).

- To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, management determines the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that 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 (IAS 23R paragraph14).

The following example illustrates how to calculate the amount of borrowing costs to be capitalised.

Example

On 1 July 2006, entity A entered into a C2.2 million contract for the construction of a building. The building was completed at the end of June 2007. During the period, the following payments were made to the contractor:

Payment date	Amount (C'000)
1 July 2006	200
30 September 2006	600
31 March 2007	1,200
30 June 2007	200
Total	**2,200**

Entity A's borrowings as at its year end of 30 June 2007 were as follows:

1. 10% four-year note with simple interest payable annually, which relates specifically to the project; debt outstanding at 30 June 2007 amounted to C700,000. Interest of C65,000 was incurred on these borrowings during the year, and interest income of C20,000 was earned on these funds while they were held in anticipation of payments.
2. 12.5% 10-year note with simple interest payable annually; debt outstanding at 1 July 2006 amounted to C1,000,000 and remained unchanged during the year.
3. 10% 10-year note with simple interest payable annually; debt outstanding at 1 July 2006 amounted to C1,500,000 and remained unchanged during the year.

Assume for purposes of this example that interest expenses equals borrowing costs.

Solution

Expenditures incurred in obtaining a qualifying asset are first allocated to any specific borrowings. The remaining expenditures are allocated to any general borrowings.

Analysis of expenditure

	Expenditure (C'000)	Amount allocated to general borrowings (C'000)	Weighted for period outstanding (C'000)
1 July 2006	200	0	0
30 September 2006	600	100*	100 x 9/12
31 March 2007	1,200	1,200	1,200 x 3/12
30 June 2007	200	200	200 x 0/12
Total	**2,200**		**375**

*Specific borrowings of C700,000 are fully utilised; remainder of expenditure is therefore allocated to general borrowings.

The capitalisation rate relating to general borrowings is the weighted average of the borrowing costs applicable to the entity's borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Weighted average borrowing cost: 12.5% (1,000/2,500) + 10% (1,500/2,500) = 11%

Borrowing cost to be capitalised

	Amount (C)
Specific loan	65,000
General borrowings (C375,000 x 11%)	41,250
Total	**116,250**
Less interest income on specific borrowings	(20,000)
Amount eligible for capitalisation	**86,250**

Therefore, the borrowing costs to be capitalised are C86,250.

Interaction between IAS 23 and IAS 11

A contract accounted for under IAS 11 is financed with general borrowings and is in a net credit position (advances in excess of costs incurred). Is the net interest income treated as a contract 'cost'?

No. If the contract is in a net credit position during the whole construction period, no costs are capitalised. The constructor has not incurred any borrowing costs that are directly attributable to the construction.

The net position in a contract may change over the construction period from net debit to net credit (or vice versa). Capitalisation is required for those periods when the contract is in a net debit position.

Does the amount of borrowing costs capitalised under IAS 11 become part of the cost that is used as a measure for the stage of completion?

Borrowing costs that are attributable to contract activity are considered to be part of the contract costs. The cost-to-cost method will generally take into account all actual costs incurred and expected costs to complete when measuring the stage of completion. Costs that do not reflect the stage of completion (for example – costs that relate to future activity (IAS 11 paragraph 27) are excluded. This might include borrowing costs incurred on specific borrowings obtained in advance for the whole project).

Transition, first-time adoption and US GAAP differences

What is the effective date of IAS 23R?

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

Entities preparing financial statements in accordance with IFRSs as adopted by the EU cannot apply IAS 23R until it is endorsed.

Should management restate the comparative period(s) in its financial statements if it decides to adopt IAS 23R from a date that is before the opening balance sheet date of the current year presented?

IAS 23R is applied prospectively from the date elected for early application. If this date is before the opening balance sheet of the current reporting period, the early application would result in restating the numbers of the prior-year financial statements. Therefore, the comparatives in the financial statements for the current period will show the effect of the prospective application of IAS 23R from the earlier date.

Are companies that capitalised borrowing costs under IAS 23 affected by IAS 23R?

No. Most companies will not be affected, as the guidance regarding the determination of the amount of the borrowing costs eligible for capitalisation, commencement, suspension and cessation of capitalisation remain substantially unchanged.

A company that capitalised borrowing costs on inventories or assets measured at fair value might be affected, as this is no longer required under IAS 23R.

Under previous GAAP, a first-time adopter was capitalising borrowing costs using a methodology different from IAS 23R. Can the same methodology be used for the assets under construction at the date of transition to IFRS?

No. A first-time adopter has the following two options under IFRS 1 for the assets already under construction at the date of transition to IFRS:

- Measure the assets in accordance with other standards (IAS 16, IAS 38, IAS 11) without capitalising any borrowing costs (alternatively, some assets can be measured at fair value in accordance with IFRS 1 if certain conditions are met); or
- Designate a date before the transition date that coincides with the commencement date of capitalisation under IAS 23R. Borrowing costs are measured and capitalised under IAS 23R from this date forward.