THE ANNUAL FINANCIAL REPORTING WEEK

IAS23/IPSAS 5/Section 25 IFRS for SMEs

- *Borrowing Cost*

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Objective and scope

Objective

The standard prescribes the accounting treatment for borrowings costs.

It generally requires the immediate expensing of all borrowing costs.

However, the standard permits the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

Scope

- The standard shall be applied in accounting for borrowing costs

Outline of borrowing costs

Borrowing costs definition

Borrowing costs relate to interest and other expenses incurred by an entity in connection with the borrowing of funds.

Borrowing costs include:

- interest on bank overdrafts
- interest on short term loans
- interest on long term loans
- amortization of discounts or premiums relating to borrowings
- amortization of ancillary costs incurred in connection with the arrangement of borrowings
- finance charges in relation to finance leases
- exchange differences arising from foreign currency borrowings

Treatment of borrowing costs

Benchmark treatment

- Under the benchmark treatment, borrowing costs shall be recognized as an expense in the period in which they occur, regardless of how the borrowings are applied.

- The financial statements shall disclose the accountancy policy adopted for borrowing costs.

Treatment of borrowing costs

Allowed alternative treatment

- Borrowing costs shall be recognized as an expense in the period in which they are incurred, except to the extent that they are capitalized.

- Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset shall be capitalized as part of the cost of the asset.

- Capitalization is applied when (a) It is probable that they will result in future economic benefits to the entity, and; (b) the costs can be measured reliably.

NB: Where an entity adopts the allowed alternative treatment, that treatment shall be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction, or production of all qualifying assets of the entity.

The alternative treatment

Borrowing costs eligible for capitalization

The exercise of judgement is required!

- The borrowing costs that should be capitalized are those that would be avoided if the outlays on the qualifying asset had not been made.
- The borrowing costs are the actual costs incurred on the borrowing during the period, less any investment income on the temporary investment of those borrowings. (Time lag issues)
- Where funds are borrowed generally and then used to obtain a qualifying asset, the amount eligible for capitalization shall be determined by applying a capitalization rate to the outlays of the asset.

The alternative treatment

- When a controlling entity passes on borrowed funds to a controlled entity, the controlled entity may only capitalize borrowing costs which it itself incurs. When the borrowing is interest free, it will not incur borrowing costs and consequently will not incur borrowing costs.

- If the controlling entity passes on borrowings at partial or full cost to the controlled entity, the controlled entity may capitalize the same, provided that appropriate consolidation adjustments are passed to eliminate the costs capitalized.

The alternative treatment

Excess of the carrying amount of the qualifying asset over recoverable amount

When a carrying amount of the qualifying asset exceeds its recoverable amount, the carrying amount is written down in accordance with the requirements of IAS 36 (Impairment of Assets), IPSAS 21 (impairment of non cash generating assets), or IPSAS 26 (impairment of cash generating assets)

The alternative treatment

Commencement of capitalization

The capitalization of borrowings costs as part of the cost of a qualifying asset shall commence when:

- Outlays for the assets are being incurred (includes cash payment, transfer of assets or assumption of interest bearing liabilities)
- Borrowing costs are being incurred
- Activities that are necessary to prepare the asset for its intended use or sale are in progress. (includes technical and administrative work prior to construction, as well as construction itself)

The alternative treatment

Suspension of capitalization

The capitalization of borrowings costs shall be suspended during extended periods in which active development is interrupted and expensed. These then become holding costs.

NB: Capitalization is not stopped when the temporary delay is necessary part of getting the asset ready for its intended use, or if temporary situations arise during which the development must be halted.

The alternative treatment

Cessation of capitalization

- The capitalization of borrowings costs shall cease when ‘substantially’ all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

- When construction of a qualifying asset is completed in parts, and each part is capable of being used while construction continues on other parts, capitalization of borrowing costs shall cease when ‘substantially’ all the activities necessary to prepare that part for its intended use or sale are completed.

Judgement must be exercised! Any Known examples?

Disclosure

The financial statements shall disclose:

- The accounting policy adopted for borrowing costs
- The amount of borrowing costs capitalized during the period
- The capitalization rate used to determine the amount of borrowing costs eligible for capitalization (When it is necessary to formulate such a capitalization rate.)

Effective date of IAS 23/IPSAS 5

Effective date

An entity shall apply this standard for annual financial statements covering periods beginning on or after 1993 (IAS 23) and July 1, 2001 (IPSAS 5).

When an entity adopts the accrual basis of accounting defined by IAS/IPSAS's, the standard applies to the entity's annual financial statements covering periods beginning on or after the date of adoption.

Comparison of IPSAS 5 to IAS 23

Comparison in brief

IPSAS 5 is derived from IAS 23 - Borrowing costs (1993).

The main differences between the 2 are as follows:

- Commentary additional to that in IAS 23 has been included in IPSAS 5 to clarify the applicability of the standards to accounting by public sector entities.

- IPSAS 5 uses different terminology in certain instances from IAS 23. Some of these are: ‘revenue’ instead of ‘income’, ‘statement of financial performance’ instead of ‘income statement’ and ‘net assets/equity’ instead of ‘equity’

Summary of Differences between IFRS for SMEs and IFRSs – Borrowing Costs

"Full IFRSs"

- Borrowing Costs are Capitalized if Certain Criteria are met
- IAS 23 revised effective 1 January, 2009 eliminated choice to capitalize or expense

IFRS for SMEs

- Borrowing costs are recognized as a period expense immediately
- Section 25 – IFRS for SMEs

- IPSAS 5 Borrowing costs – Benchmark treatment and alternative treatment

COP - Capitalisation of Borrowing Costs

Q. Whether borrowing cost avoidable or unavoidable?

A. Said to be unavoidable if expenditure on qualifying assets had been incurred and borrowing is taken, Existing borrowing exercise of judgement required.

Q. Factors to be considered as to whether and to what extent general borrowings have been so used

A. Information of cash inflows and outflows, close scrutiny required.

Q. General borrowings made but equity specifically infused for financing qualifying assets

A. No question of capitalizing borrowing cost.

Q. Calculation of weighted average borrowing rate?

A. Based on borrowing during period of expenditure and not borrowings made for the whole year.

Capitalisation of completed parts of a project

Q. Capitalisation of commissioned packages when capitalization of remaining incomplete packages is pending?

A. Necessary to capitalize commissioned packages .

Q. Date of capitalization?

A. Date on which package is ready to commence commercial production.

Q. Allocation of incidental expenditure during construction?

A. On appropriate basis.

Q. Capitalisation of independent packages which are complete when capitalization of main packages is pending ?

A. Capitalised when ready for their intended use.

Capitalisation of completed parts of a project

Apex issued a Sh.10 million unsecured loan with a coupon (nominal) interest rate of 6% on 1 April 2018. The loan is redeemable at a premium which means the loan has an effective finance cost of 7·5% per annum. The loan was specifically issued to finance the building of the new store which meets the definition of a qualifying asset in IAS 23. Construction of the store commenced on 1 May 2018 and it was completed and ready for use on 28 February 2019, but did not open for trading until 1 April 2019. During the year trading at Apex's other stores was below expectations so Apex suspended the construction of the new store for a two-month period during July and August 2018. The proceeds of the loan were temporarily invested for the month of April 2018 and earned interest of Sh.40, 000.

Calculate the net borrowing cost that should be capitalised as part of the cost of the new store and the finance cost that should be reported in the income statement for the year ended 31 March 2019.

The End

Thank You!!