Grant Thornton

Technical Accounting Alert

AASB 123 *Borrowing Costs*

Introduction

The Australian Accounting Standards Board ("AASB") has issued revised AASB 123 *Borrowing Costs.*

In the revised standard, the previous benchmark treatment of recognising borrowing costs as an expense has been eliminated. Instead, borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets form part of the costs of that asset.

Which borrowing costs are eligible for capitalisation?

The revised standard considers interest and other costs that an entity incurs in connection with the borrowing of funds as borrowing costs. Examples include, but are not limited to, interest on borrowings, the amortisation of discounts or premiums and finance charges in respect of finance leases recognised under AASB 117 *Leases.* Actual or imputed costs of equity, however, do not fall within the scope of this standard.

To be eligible for capitalisation, borrowing costs must be directly attributable to the acquisition, construction or production of a qualifying asset:

- To the extent that credit is raised to specifically obtain a qualifying asset, the entity needs to capitalise the actual borrowing costs incurred. Any investment income on the temporary investment of these borrowings reduces the amount of eligible borrowing costs.
- If an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the amount of eligible borrowing costs needs to be determined by applying a capitalisation rate to the expenditures on that asset.

What are qualifying assets within the scope of AASB 123 (Revised)?

Assets that necessarily take a substantial period of time to get ready for its intended use or sale are generally considered qualifying assets. Common examples include manufacturing plants and power generating facilities, intangible assets and investment properties. Inventories may also be qualifying assets.

AASB 123 (Revised), however, also states a number of exceptions:

- An entity is not required to capitalise borrowing costs for assets that are subsequently measured at fair value
- The standard does not apply to inventories that are manufactured, or otherwise, produced, in large quantities on a repetitive basis;
- As a general rule, financial assets do not fall under the definition of a qualifying asset; and
- Assets that are ready for their intended use or sale when acquired are not qualifying assets as defined by the revised standard.

Capitalisation of borrowing costs in a group situation

In determining the amount of borrowing costs to be capitalised in the separate financial statements of the parent or individual financial statements of a subsidiary, the eligible pool of borrowing costs can include costs in relation to both external and intra-group borrowings.

In determining the amount of borrowing costs to be capitalised in the consolidated financial statements, the eligible pool of borrowing costs can include only costs incurred on borrowings external to the group.

Capitalisation of interest in consolidated financial statements for a particular asset may be required even if the qualifying asset is being constructed or developed by a group entity that has not incurred eligible borrowing costs. A parent entity might for example borrow funds externally and provide finance to its subsidiaries in the form of equity or 'on-demand' loans on which no interest is recognised in accordance with AASB 139 *Financial Instruments: Recognition and Measurement*. Borrowing costs are however capitalised to the extent they are directly attributable to the acquisition, construction or production of a qualifying asset. This is the amount of borrowing costs incurred by the group that would have been avoided if the expenditure on the qualifying asset had not been made. In this type of group situation judgement may be required to determine the manner in which the AASB 123 directly attributable test is met.

Practical difficulties are often encountered in a group situation in deciding whether borrowing costs are directly attributable to the acquisition, construction or production of a qualifying asset, particularly where the borrowings are incurred by one group company but construction of an asset takes place within another group company.

Such problems are mentioned in AASB 123.11, which states:

> "It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required"

Capitalisation of interest within separate financial statements

In determining the amount of borrowing costs to be capitalised in the separate financial statements of a parent or individual financial statements of a subsidiary, the eligible pool of borrowing costs can include costs in relation to both external and intra-group borrowings.

Example 1 - Identifying eligible borrowing costs and qualifying assets
A group consists of the parent P and two subsidiaries, A and B. A is engaged in the construction of a business park with funding being provided by B which charges intra-group interest at a market rate. The parent P and subsidiary B are cash-rich, and the group as a whole has no external borrowings.
Can the finance costs on the borrowings be capitalised in the individual financial statements of A or B or the consolidated financial statements of P?

In this situation A must capitalise interest, as it has both a qualifying asset (the construction of the business park) and borrowing costs (the intra-group interest charged by B). At individual company level, it is irrelevant that A's borrowings are not external to the group as a whole although at consolidated financial statements level it will mean that capitalisation of interest is not possible. It is not possible to capitalise interest in B's separate financial statements as it has no qualifying asset

Capitalisation of interest within consolidated financial statements

AASB 123.8's requirement that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset be capitalised as part of the cost of that asset applies equally to consolidated financial statements.

Capitalisation of borrowing costs in consolidated financial statements can however occur without there being capitalisation of borrowing costs in the separate financial statements of companies within the group. This is because the consolidated financial statements are prepared as if the group is effectively a single company.

Such a situation can occur when construction of an asset takes place in one company but borrowing costs are incurred in another company within the group, or where the definition of a qualifying asset is not met in a company's separate financial statements but is at consolidated financial statement level.

Intra-group borrowings

Intra-group borrowings are often made on an interest-free basis or at a rate of interest that is less than would be charged in an arms length transaction. This means that applying AASB 139's effective interest rate method to determine the borrowing costs to be capitalised (AASB 123.6(a)) may result in a different level of borrowing costs being capitalised to that actually charged.

This difference is not relevant to the consolidated financial statements, as borrowing costs at a consolidated level is determined by borrowings external to the group (intra-group interest cancelling out on consolidation). It may however need to be considered in the separate financial statements of a parent or the individual financial statements of a subsidiary

Example 2 - construction in one subsidiary, borrowing costs incurred in another subsidiary
Interest-free loan repayable on demand
A group consists of the parent P and a number of subsidiaries, including A. As in example 1, A is engaged in the construction of a business park but the group is not cash rich. P therefore borrows externally and lends money on to other subsidiaries within the group, including subsidiary A, on an interest-free basis. The intra-group loans made are repayable on demand.
Can the finance costs on the bank borrowings be capitalised in the separate financial statements of A or P or in the consolidated financial statements of P?
In this situation, there is no intra-group interest charge. Accordingly, no interest should be capitalised in either of the separate financial statements of A or P. A has incurred no borrowing costs, and P has no qualifying asset. Also, because AASB 139 requires on-demand borrowings to be reported at the amount repayable on demand, no interest expense is recorded on the intra-group borrowings in these circumstances (AASB 139.49).

At consolidated financial statement level, however, the group is viewed as if it were a single company, meaning that there is both a qualifying asset and borrowing costs on the external bank borrowings. Interest is capitalised to the extent that borrowing costs incurred are directly attributed to the construction of the qualifying asset. AASB 123.10 states that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Interest-free fixed term loan not repayable on demand
If the loan made by the parent to its subsidiaries is not repayable on demand and is for a fixed term then discounting to fair value needs to be considered. If a loan is provided at a rate of interest which is less than the market rate and the loan is not repayable on demand, then the fair value of the loan on initial recognition will differ from the proceeds received. The 'unwinding' of this difference should be reported as interest expense in accordance with AASB 139's effective interest method.
AASB 123.6(a)* states that borrowing costs may include "interest expense calculated using the effective interest rate method as described in AASB 139 *Financial Instruments: Recognition and Measurement*". Accordingly it is required to capitalise the unwinding of the difference between the fair value of the loan and the loan proceeds.

Where the definition of a qualifying asset is not met in a company's separate financial statements but is at consolidated financial statement level, it will be necessary to make an assessment of how much of the borrowing costs in the group are directly attributable to the construction of the qualifying asset in order to correctly capitalise borrowing costs under AASB 123. As noted in AASB 123.11, this can be a difficult exercise. The following example indicates some of the matters to be considered in such a scenario.

Example 3 - definition of qualifying asset met at consolidated financial statements level but not in separate financial statements.

An entity acquires a subsidiary, incurring borrowings to fund part of the consideration for the acquisition. The subsidiary is constructing a property, and has existing borrowings which are being used to finance the construction of the property. Is it possible to treat the property as a qualifying asset in the subsidiary's separate financial statements or the group's consolidated financial statements, and if so how much can be capitalised?

As investments are deemed not to be qualifying assets per AASB 123.7, it is not possible to capitalise borrowing costs in the individual financial statements of the parent. In the consolidated financial statements however, the group is viewed as if it were a single company meaning that the investment in the subsidiary is replaced by its underlying net assets including the property. At consolidated financial statements level then, an assessment must be made of how much of the borrowing costs in the group are directly attributable to the borrowings for the construction of the qualifying asset.

In relation to the determination of the amount of directly attributable borrowing costs, the property will be initially recognised on acquisition in the consolidated financial statements at fair value in accordance with the requirements of AASB 3 *Business Combinations (Revised 2008)*. This amount is treated as the 'cost' of the property for the purpose of capitalising borrowing costs in the consolidated financial statements. Care must be taken however not to double count the borrowing costs incurred - the specific borrowing costs incurred by the subsidiary must be capitalised first, after which a proportion of the borrowing costs incurred by the parent should be capitalised.

Illustrating this point numerically, Company A acquires Company B, paying $ 50,000, which is financed by cash of $ 20,000 and borrowings of $ 30,000. Costs incurred on these borrowings in the period between the acquisition date and the end of the reporting period were $ 2,000.

Company B's net assets consist of the following:

	Book cost ($)	Fair value on acquisition ($)
Property under construction *	40,000	50,000
Other assets	20,000	20,000
Borrowings related to property	(20,000)	(20,000)
Net assets	40,000	50,000

* Note that the example assumes that all of the borrowing costs incurred relate to the period during which the property is under construction. For simplicity, it also assumes that the value of the property does not change during that period, although in practice the value would change as construction progresses which would have a knock-on effect on the determination of the amount of directly attributable borrowing costs.

In the period between the acquisition date and the end of the reporting period, Company B incurred borrowing costs of $ 1,000.

In this example, the cost of the property to be recognised in the consolidated financial statements on acquisition is its fair value of $ 50,000. The borrowing costs that can be capitalised are the $ 1,000 of borrowing costs incurred directly by subsidiary B in relation to the construction of the property and those borrowing costs incurred by the parent A which can be said to be directly attributable to the construction of the property.

The parent company has borrowed $ 30,000 in relation to the acquired subsidiary. The assets of the subsidiary consist of the property of $ 50,000 and other assets of $ 20,000. As the property is being financed directly by $ 20,000 of borrowings, one view would be that it is reasonable to regard 60% of the parent company's borrowings (reflecting the value of the subsidiary's property less the subsidiary's borrowing costs directly relating to the property relative to the subsidiary's other net assets) as being directly attributable to the $ 30,000 part of the property that is not being financed by the subsidiary's borrowings. Using this method of determining what is directly attributable to the construction of qualifying asset means that $ 1,200 of the parent company's borrowing costs can be capitalised in the consolidated financial statements. The other $ 800 of the parent company's borrowing costs (representing the two fifths of the parent company's borrowings which relate to the remaining assets of company B of $ 20,000) are not capitalised. In total then, $ 2,200 of interest costs are capitalised - $ 1,000 of interest costs incurred directly by the subsidiary and $ 1,200 of the parent's borrowing costs (representing the three fifths of the parent's total costs of $ 2,000 that are directly attributable to the construction of the property).

Alternative methods of determining the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset are possible however. In the above example for instance, an alternative argument could be made for 'top slicing' the borrowing costs and saying that $ 30,000 of the parent's borrowings relate to the corresponding $ 30,000 of the subsidiary's property under construction that has not been funded by the subsidiary's own borrowings. In other words, if the asset had not been acquired, none of that $ 30,000 of borrowings would have been needed, and hence all the $ 2,000 borrowing costs on that $30 000 would have been avoided. Thus all of the $2 000 qualifies for capitalisation.

The most appropriate method of determining the amount of directly attributable borrowing costs is likely to depend upon the specific facts and circumstances of the particular situation, including such factors as the reason for entering into the transaction in a particular way, and the nature of group treasury and overall financing arrangements. Attention should be paid to ensuring transparent disclosure of the method adopted, as a judgement under AASB 101 Presentation of Financial Statements (Revised 2007) where material (AASB 101.122).

Effective date

The revised version of AASB 123 *Borrowing Costs* needs to be applied for annual periods beginning on or after 1 January 2009. Earlier adoption is permitted.

Application of the transitional provisions

If an entity constructs or produces qualifying assets and has previously adopted a policy of expensing borrowing costs immediately, it will be required to change its accounting policy in order to comply with AASB 123 (revised 2007). The revised Standard must be applied to annual reporting periods beginning on or after 1 January 2009.

The entity should start capitalising borrowing costs relating to all qualifying assets for which the 'commencement date' for capitalisation is on or after the effective date for application of the revised standard

Effective date

The 'effective date' for the purpose of applying IAS 23 (revised 2007) is:

- 1 January 2009 for an entity that prepares financial statements on a calendar year-end basis
- otherwise the beginning of the first annual reporting period after that date (eg 1 April 2009 for an entity that prepares financial statements to 31 March each year).

Commencement date

The commencement date for a particular asset is the date when the entity meets **all** the following conditions:

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

Consequently, an entity that applies the previous benchmark treatment and recognises all borrowing costs as an expense in the period in which they are incurred will have a choice on initial application of the revised standard. It can continue to expense borrowing costs on those qualifying assets in the course of construction or production at the effective date and only begin to capitalise borrowing costs in respect of those qualifying assets whose commencement date is after the effective date.

Alternatively, it can designate an earlier date as the effective date. This earlier date can be part way through an accounting period, for example the date that a particular construction project is started. It will then capitalise borrowing costs in respect of qualifying assets whose commencement date for capitalisation is on or after this designated date.

Example 1 – Existing preparer
Entity A is engaged in the construction of two qualifying assets. Both projects are financed by specific bank borrowings. The commencement date for capitalisation for Project One is 1 December 2008 and for Project Two is 1 July 2009. Entity A prepares its financial statements to 31 March each year. Its accounting policy is to recognise all borrowing costs as an expense in the period in which they are incurred.

How should entity A apply the change in accounting policy for borrowing costs on initial application of the revised standard?

Entity A will apply the revised standard in preparing its financial statements for the year ended 31 March 2010. The relevant effective date is therefore 1 April 2009.

Entity A will not restate the comparatives in respect of those borrowing costs incurred prior to 1 April 2009 on Project One. Borrowing costs incurred after 1 April 2009 in relation to Project One will also continue to be expensed.

Borrowing costs incurred on Project Two will be capitalised from 1 July 2009 until the activities necessary to prepare the asset for its intended use or sale are complete.

Entity A may choose to designate an earlier date for adoption of the revised standard, for example 1 December 2008. If it does so then borrowing costs incurred in relation to Project One for the period 1 December 2008 to 31 March 2009 will be capitalised in the March 2009 financial statements.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au