



# HM TREASURY

## Financial Reporting Advisory Board Paper

### IAS 23 *Borrowing Costs*

<b>Issue:</b>	The application of IAS 23 <i>Borrowing Costs</i> in the context of resource and other accounts covered by the Government Financial Reporting Manual (FReM)
<b>Impact on guidance:</b>	The proposed text in Annex A relates to the IFRS-based FReM.
<b>IAS/IFRS adaptation?</b>	No
<b>IPSAS compliant?</b>	Yes – IPSAS 5 <i>Borrowing Costs</i> (drawn from IAS 23)
<b>Interpretation for the public sector context?</b>	Yes – Under FRS 15 <i>Tangible Fixed Assets</i> the capitalization of finance costs, including interest, is optional. The interpretation for the public sector context in the current FReM is that entities shall not capitalize any finance costs that are directly attributable to the construction of tangible fixed assets. This makes it clear to entities that they should not be capitalizing their cost of capital charge, nor any interest costs an entity exceptionally incurs. This interpretation will also be adopted for IAS 23.
<b>Impact on budgetary regime?</b>	None
<b>Alignment with National Accounts</b>	Yes (with adoption of interpretation, as interest is a current distributive transaction in national accounts and scores against the current balance).
<b>Impact on Estimates?</b>	None
<b>Recommendation:</b>	That the Board agrees that IAS 23 applies in full subject to the interpretation above.
<b>Timing:</b>	Not yet known: depends on future decision on date for moving to EU-adopted IFRS.

## **DETAIL**

### ***Background***

1. IAS 23 *Borrowing Costs* sets out the accounting treatment for borrowing costs and is applicable for periods beginning on or after 1<sup>st</sup> January 1995.
2. The Standard generally requires the immediate expensing of borrowing costs. However, the Standard permits, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

### ***Definitions***

3. Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds.
4. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

### ***Benchmark treatment***

5. The benchmark treatment for borrowing costs is that they shall be recognized as an expense in the period in which they are incurred.

### ***Allowed alternative treatment***

6. 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 that asset. Borrowing costs directly attributable are those that would have been avoided if the expenditure on the qualifying asset had not been made. Such borrowing costs are capitalized as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably.
7. Where the allowed alternative is adopted, that treatment should be applied consistently to all borrowing costs incurred for the acquisition, construction or production of qualifying assets.
8. Where funds are borrowed specifically, costs eligible for capitalization are the actual costs incurred less any income earned on the temporary investment of such borrowings. Where funds are part of a general pool, the eligible amount is determined by applying a capitalization rate to the expenditure on that asset. The capitalization rate will be the weighted average of the borrowing costs applicable to the general pool.
9. The capitalization of borrowing costs should commence when expenditures are being incurred, borrowing costs are being incurred, AND activities that are necessary to prepare the asset for its intended use or sale are in progress.
10. Capitalization should be suspended during periods in which active development is interrupted. Capitalization should cease when substantially all of the activities necessary to prepare the asset for its intended use or sale are complete. Where construction is completed in stages, and the part

completed can be used while construction of the other parts continues, capitalization of attributable borrowing costs should cease when substantially all of the activities necessary to prepare that part for its intended use or sale are complete.

#### *Exposure draft of proposed amendments to IAS 23*

11. The IASB is currently undertaking a convergence project considering whether and how to converge IAS 23 *Borrowing Costs* and FAS 34 *Capitalization of Interest Cost*. IAS 23 permits the two treatments set out above. In contrast, FAS 34 requires the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. The immediate expensing of such costs is not an option. On 25 May 2006, the IASB published an Exposure Draft of proposed amendments to IAS 23. The Exposure Draft proposed requiring an entity to capitalize borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. The option of immediately recognizing those borrowing costs as an expense will be removed from the standard. Comments were received by 29 September 2006. There was a divergence of opinions between both respondents and Board members as to whether to adopt the proposal or terminate the project. Due to the comments and the split view by Board members it was decided at the November 2006 IASB Meeting that staff should do further analysis on comments from respondents before the Board decides how to proceed.

#### ***Impact on disclosures in resource and other accounts***

12. Adoption of the proposed text in the FReM is not expected to impact on disclosures in resource and other accounts.

#### ***IAS/IFRS compliance***

13. The proposal is to adopt IAS 23 as interpreted - that entities shall not capitalize any borrowing costs that are directly attributable to the acquisition, production or construction of qualifying assets. This follows the guidance published in earlier versions of the FReM/RAM prohibiting capitalization of any finance costs (including the cost of capital charge) that are directly attributable to the construction of tangible fixed assets (an interpretation of FRS 15 for the public sector context).

#### ***IPSAS compliance***

14. IPSAS 5: *Borrowing Costs* prescribes the accounting treatment for borrowing costs. It draws heavily on IAS 23 and is consistent with it, and as such this proposal is compliant with the standard.

#### ***Proposed text for the IFRS-based Government Financial Reporting Manual***

15. See Annex A for the proposed amendments to the IFRS-based FReM.

#### ***Impact on the budgetary regime***

16. No impact on budgetary regime.

***Summary and recommendation***

17. It is recommended that the IFRS-based FReM adopt IAS 23, as interpreted, pending the outcome of IASB work on converging IAS 23 and FAS 34. The work of the IASB will continue to be monitored and the outcome of the convergence project considered and brought to the attention of the FRAB.

**HM Treasury**  
**12 February 2007**

## **PROPOSED TEXT FOR THE IFRS-BASED GOVERNMENT FINANCIAL REPORTING MANUAL**

### *IAS 23: Borrowing Costs*

#### ***Applicability***

IAS 23 Borrowing Costs applies as interpreted to all entities covered by this Manual.

#### ***Objectives of IAS 23 Borrowing Costs***

The Standard prescribes the accounting treatment for borrowing costs. The Standard generally requires the immediate expensing of borrowing costs. However, the Standard permits, as an allowed alternative treatment, the capitalization of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

#### ***Interpretation of IAS 23 for the public sector context***

In applying IAS 23, entities should be aware of the following interpretation for the public sector context.

##### *Recognition*

Entities shall **not** capitalize any borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.