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IAS® Standard 23 Borrowing Costs



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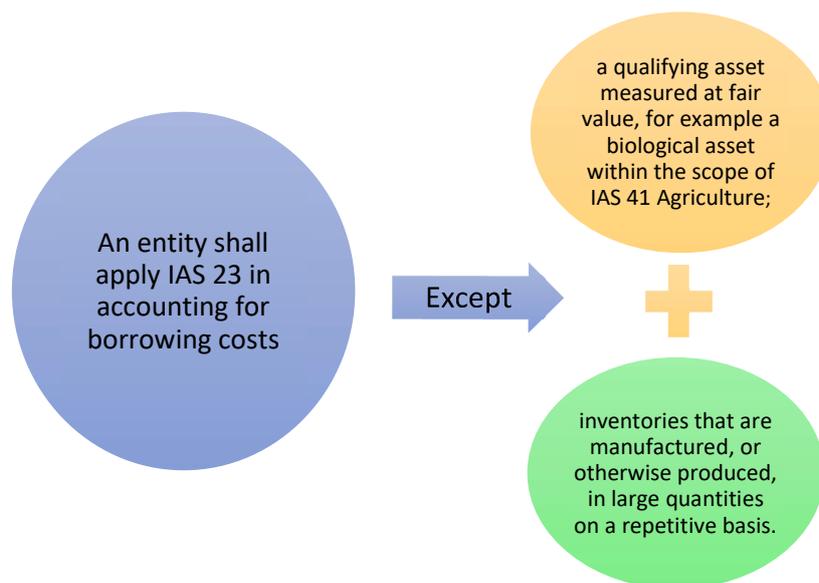
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IAS® Standard 23 Borrowing Costs

SCOPE AND KEY DEFINITIONS

IAS Standard 23 Borrowing Costs affects all entities which acquire, construct or produce a qualifying asset and have a borrowing cost at the same time. As shown in Figure 1, IAS 23 applies to all companies except for transactions regarding a qualifying asset measured at fair value such as a biological asset or producing a product, on a repetitive basis, in large numbers.

Figure 1. Scope of companies to implement IAS 23



For financing purposes, an entity might choose to finance its investments with its own resources which leads to a cost of capital. However, actual or imputed cost of equity, including preferred stock not classified as liability, is out of the scope of this standard; IAS 23 applies to borrowing costs only.

To understand this standard correctly, we must know two basic definitions: Borrowing costs and qualifying assets. These are defined in the standard as follows (IAS 23.5):

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

Borrowing costs may include (IAS 23.6):

- (a) interest expense calculated using the effective interest method as described in IFRS Standard 9 Financial Instruments;
- (b) interest in respect of lease liabilities recognised in accordance with IFRS Standard 16 Leases; and
- (c) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

There are basically two ways businesses can acquire an asset; purchase and build or produce. In some cases, acquiring an asset takes a substantial amount of time and requires external financing. For

example, if you want to buy a phone, you can buy it from a technology store or buy it online. You can buy it with cash or on credit. If the seller provides you with credit, then you have to pay interest. The interest you pay is a choice or a matter of your cash management. However, if you want to build a new house, in this case, you cannot own the house immediately because construction will last for a substantial period. And it is often necessary to use external financing to finance the expenditures to be made for the house. IAS 23 allows the capitalisation of the interest costs made in this substantial period. However, there are no clear instructions for determining the substantial period. While determining the substantial period requires professional judgment, in practice it is generally accepted that this period should be one year or more.

RECOGNITION AND MEASUREMENT

The fundamental principle of IAS 23 is capitalising borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset and recognizing other borrowing costs as expenses in the period in which it incurs them.

For businesses to account for borrowing costs in accordance with IAS 23:

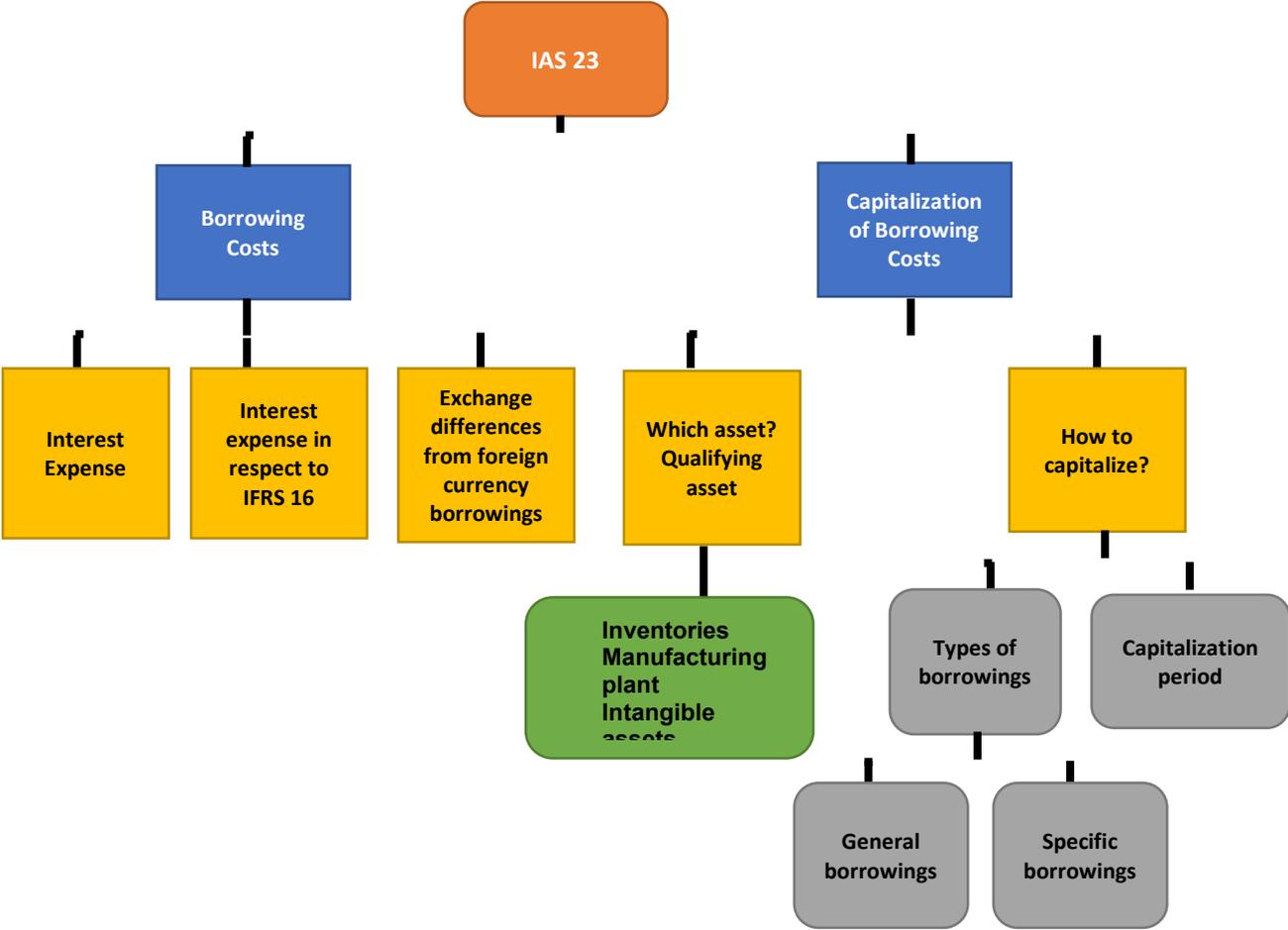
- The entity must have a specific and/or general borrowing that incurs borrowing costs.
- There must be a qualifying asset and expenditures should be made for that qualifying asset.

However, an important criterion here is that when no expenditures are made for the qualifying asset, the related borrowing cost can be avoided. For general borrowings, the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset could be difficult to determine and the exercise of judgement might be required.

PROCEDURES

The application of IAS 23 includes calculating the total amount of the borrowing cost and calculating the borrowing cost to be capitalised, as shown in Figure 2.

Figure 2. Application of IAS 23



1. Calculation of Total Borrowing Costs

The entity must determine the total amount of borrowing costs shown in Figure 2. Related borrowing costs may have resulted from specific and general borrowings. However, if the business has earned interest income by using special borrowings, this amount should be deducted from the relevant interest cost. This does not apply to general borrowings.

2. Deciding On the Qualifying Asset

Second issue is deciding which assets are qualifying assets. When deciding on the qualifying asset, these do not have to be only tangible assets that can be accounted for in accordance with IAS 16 Property, Plant and Equipment. The qualifying asset can be an inventory item or an intangible asset. The critical point here is that a substantial time must pass in order to have a qualifying asset. There are no guidelines regarding substantial time, so professional judgment should be used. However, in general, when it takes more than 1 year to acquire an asset, there is a custom for that asset to be considered a qualifying asset.

3. Calculation of Capitalised Borrowing Costs

After the qualifying asset is determined, the borrowing costs to be capitalised on the qualifying asset must be calculated. While calculating this amount, attention should be paid to the type of borrowing and the capitalisation period as shown in Figure 2.

The entity may have made a special borrowing for financing the acquisition or construction of the qualifying asset, or it may have decided to finance the qualifying asset with general borrowings it has already made or both. After determining the relevant borrowing costs, the second step is to determine in which time period these borrowing costs will be capitalised. Total borrowing costs that are directly related to the acquisition and construction of the qualifying asset during the capitalisation period should be calculated. Calculation of borrowing costs depends on using specific or general borrowing.

Special Borrowings

Borrowing costs for loans taken specifically are called specific borrowing costs, while others are called general borrowing costs. To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by the actual borrowing costs incurred on that borrowing during the period minus any investment income on the temporary investment of those borrowings.

For example, suppose a business borrows CU 4,000,000 from a bank for an administrative building costing CU 5,000,000 that will take two years to build. The borrowing cost of these 4 million loans will be added to the cost of the qualifying asset during the capitalisation period as the specific borrowing cost.

Now assume that the company had a total borrowing cost of CU 80,000 from specific borrowing, however, the company also earned a total investment income of CU 20,000 from investing the same specific borrowing. Then the net amount of borrowing cost that should be added to the cost of qualifying asset is CU 60,000.

Continuing with the example above, the remaining CU 1 million can be financed with the equity of the enterprise or with the previous loans. If the entity finances it with equity, no action will be taken for this part. Because the cost of equity is not considered as a borrowing cost and cannot be capitalised within the framework of this standard.

If the remaining amount is financed with previous borrowings, the borrowing costs will need to be capitalised. In this case, it is necessary to calculate a common borrowing cost rate, which is called capitalisation rate, for these borrowings in different amounts and with different interest rates.

An important issue regarding specific borrowing costs is the temporary use of the debt taken for qualifying asset in investment and earning interest income. In this situation borrowing costs eligible for capitalisation will be the actual borrowing costs incurred on that borrowing during the period minus any investment income on the temporary investment of those borrowings.

General Borrowings

To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.

Suppose now that an entity has two general borrowings for a qualifying asset that it can use at the beginning of the capitalisation period. Those are:

- A loan with 10% interest with CU 10 million principal and,
- A loan with 14.5% interest with CU 8 million principal.

The entity will face the problem of which interest rate it should calculate the borrowing cost for the expenditures it has made for the qualifying asset. The solution to this problem is to calculate a weighted average borrowing cost for general borrowings.

Capitalisation Rate

The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity shall exclude borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset from this calculation until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurs during that period.

To find the capitalisation rate, the total cost of interest on general borrowings must be divided by the total principal on general borrowings. Continuing from the example above, the borrowing costs of these general borrowings are CU 1,000,000 and CU 1,160,000. These are calculated as follows:

$$\text{Borrowing cost of first loan: } CU\ 10,000,000 * 10\% = CU\ 1,000,000$$

$$\text{Borrowing cost of second loan: } CU\ 8,000,000 * 14.5\% = CU\ 1,160,000$$

The total amount of the borrowing costs is CU2,160,000. The capitalisation rate is calculated as 12% when the total interest cost of CU2,160,000 is divided by total principal amount of CU18,000,000.

$$\text{Capitalisation rate} = \frac{\text{Total borrowing cost}}{\text{Total Principal Amount of Loans}}$$

$$\text{Capitalisation rate} = \frac{10,000,000 * 0.10 + 8,000,000 * 0.145}{10,000,000 + 8,000,000}$$

$$\text{Capitalisation rate} = \frac{1,000,000 + 1,160,000}{18,000,000} = 12\% \text{ or } 0.12$$

The capitalisation rate alone is not sufficient to calculate the borrowing cost to be capitalised. This ratio should be multiplied by the amount of expenditures made for the qualifying asset.

Calculation of Expenditures Financed by General Borrowings

Expenditures is another factor that needs to be adjusted in the calculation of the borrowing cost to be capitalised.

Let us suppose that a business has spent CU 100,000 on January 1 and December 31. Is the interest cost incurred by the business for both expenditures the same? The answer is definitely NO. Then, what method should be followed for expenditures made at different times?

For example, CU 100,000 spent on January 1 will incur interest costs for 12 months, and the qualifying asset will not be completed until the end of the year. In this case, there are 12 months until the end of

the capitalisation period which means that this expenditure will incur interest costs over 12 months for 12 months of the capitalisation period for the qualifying asset.

Let us assume that expenditures were made on January 1, March 1, September 1, and December 1 for construction of an entity's qualifying assets from January 1 to December 31. Let those expenditures be CU 100,000, CU 360,000, CU 300,000, and CU 240,000, respectively. The amount of weighted average expenditure is proportional to the period in which the expenditures are exposed to interest. To calculate this amount, we should weight the expenditures by the time they are incurred, as shown in Table 1. Actual expenditures are shown in the second column of Table 1 and the period of time in which those expenditures are exposed to borrowing cost are shown in the third column. When we multiply the actual expenditures in the table by the capitalisation period and add the results, we calculate the amount of weighted average expenditure for the period as CU 520,000. Now, in the final step, by multiplying CU 520,000 by the capitalisation rate we calculated in the previous step, we get the borrowing cost to be capitalised.

The amount of weighted average expenditure is calculated by proportioning the expenditures to the length of the period in which they are exposed to the interest cost. Actual expenditures are shown in the second column and the period of time in which those expenditures are exposed to a borrowing cost are shown in the third column. The expenditure made on 1 January will expose a borrowing cost for 12 months and the expenditure made on 1 September will expose a borrowing cost for 4 months.

When we multiply the actual expenditures in the table by the capitalisation period and add the results, we calculate the amount of weighted average expenditure for the period as CU 520,000.

Table 1. Weighting the Expenditures

Date	Actual Expenditure A (in CU)	Capitalisation Period B	Weighted Average Expenditure A x B (in CU)
January 1	100,000	12/12	100,000
March 1	360,000	10/12	300,000
September 1	300,000	4/12	100,000
December 1	240,000	1/12	20,000
TOTAL	1,000,000		520,000

General Borrowing Costs to be Capitalised

The capitalisation rate should be multiplied by the total weighted average expenditures in order to find the borrowing cost to be capitalised,

Now, let’s find the borrowing cost to be capitalised in building a qualifying asset with a capitalisation rate of 12% and a total weighted average expenditure of CU 520,000. CU 62,400, which is found by multiplying CU 520,000 by 12%, is the borrowing cost that will be capitalised in the cost of the qualifying asset.

Please remember the total annual borrowing cost we calculated for general borrowings, which we used when calculating the capitalisation rate. It was CU 2,160,000. Now we capitalise CU 62,400 of this amount to the cost of the qualifying asset. Then, the remaining CU 2,097,600 will be expensed.

Capitalisation Period

In the evaluation of the capitalisation period, as shown in Figure 3, the commencement and cessation dates and the possible suspension period should be determined. Commencement is the date when the entity begins to capitalise the borrowing costs.

The entity can capitalise borrowing costs when it meets all of the following conditions:

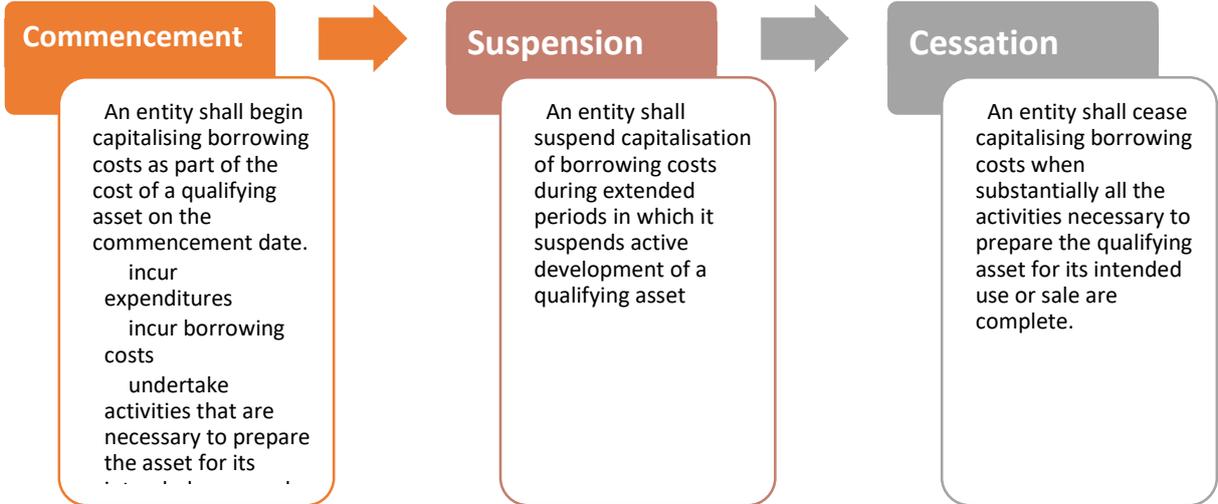
- incurring expenditures
- incurring borrowing costs
- undertaking activities that are necessary to prepare the asset for its intended use or sale

Expenditures made by the entities must consist of cash, transfers of other assets or the assumption of interest-bearing liabilities only.

An entity shall suspend the capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset. For example, during the construction of a dam, there may be breaks in the construction process within the framework of the engineering project. Borrowing costs continue to be capitalised for these periods. However, if the construction process is interrupted, for example, due to the employees going on strike, the capitalisation process should be suspended as this is not an integral part of the construction process.

An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Figure 3. Capitalisation Period



Disclosures

Finally, what information should be disclosed by businesses about borrowing costs?

An entity shall disclose:

- (a) the amount of borrowing costs capitalised during the period; and
- (b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Example

On 1 January 2020, Menderes Co. began construction worth CU 3 million. The building constructed will be used as headquarters and the construction will be completed in 18 months. During 2020, the following payments were made to the contractor:

Date and amount of payment (CU 000)	
February 1, 2020	300
March 31, 2020	700
September 30, 2020	1,000
November 30, 2020	300
Total	2,300

Borrowings of Menderes Co. at the year end on 31 December 2020 were as follows:

1. 8% four-year note with simple interest payable annually, which relates specifically to the project; amounted to CU 800,000. Interest of CU 64,000 was incurred on this loan during the year, and interest income of CU 16,000 was earned on these funds while they were held in anticipation of payments.
2. 14% 10-year note with simple interest payable annually; outstanding debt on January 1, 2020 amounted to CU 800,000 and remained unchanged throughout the year.
3. 11.5% 10-year note with simple interest payable annually; outstanding debt on January 1, 2020 amounted to CU 1,200,000 and remained unchanged throughout the year

Requirement:

Determine the borrowing cost to be capitalised in 2020 for the qualifying asset.

SOLUTION

Again, we must first decide if there are any qualifying assets. We do not capitalise the borrowing cost unless we have a qualifying asset.

There is a loan specially taken for this project. The borrowing cost of this loan is directly related to this asset. However, this borrowing cost must be a net cost. That means, any interest income generated from this fund must be deducted from the total borrowing cost of this loan.

Total Borrowing Cost= Borrowing cost from special borrowings+ Borrowing cost from general borrowings	
<p>Special Borrowings</p> <p>Total Borrowing Cost = CU64,000</p> <p>Interest Income = CU16,000</p> <p>Net Borrowing Cost = CU48,000</p>	<p>General Borrowings</p> <p>Borrowing costs from general borrowings require further calculations. First, we have to calculate the capitalisation rate, then find the amount of expenditures funded by general borrowings. If you have some special borrowings, you initially fund your expenditures</p>

from the special loan. The remaining expenditure will be funded by general borrowings.

$$\text{Capitalization rate} = \frac{\text{Total borrowing cost}}{\text{Total Principal Amount of Loans}}$$

Loans	Outstanding from January 1, 2020 to December 2020	Weighted Average Loan	Rate	Borrowing Cost (Interest Expense)
14% Loan	CU 800,000	800,000	14%	800,000*0.14=CU112,000
11.5% Loan	CU 1,200,000	1,200,000	11,5%	1,200,00*0.115=CU138,000
TOTAL		CU2,000,000		CU250,000

The capitalisation rate relating to the 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.

Now we can calculate the capitalisation rate as follows:

$$\text{Capitalisation Rate} = \frac{250,000}{2,000,000} = 12.5\%$$

Analysis of expenditure

Then, in order to find the borrowing cost to be capitalised, we have to multiply the capitalisation rate with a principal amount. That principal amount is weighted average expenditures.

Expenditure made	Nominal Amount	Expenditure funded by the special borrowing	Expenditure funded by general borrowings	Months till the year end after expenditure	Weighted average amount of expenditure
February 1, 2020	300,000	300,000	-	11	0*11/12=0
March 31, 2020	700,000	500,000	200,000	9	200,000*9/12=150,000
September 30, 2020	1,000,000	-	1,000,000	3	1,000,000*3/12=250,000
November 30, 2020	300,000	-	300,000	1	300,000*1/12=25,000
	CU2,300,000	CU800,000	CU1,500,000		CU425,000

Total amount of special borrowings. Specific borrowings of CU800,000 are fully utilized; remainder of expenditure is therefore allocated to general borrowings.

Total amount funded by general borrowings

Borrowing Cost Eligible for capitalisation from general borrowings:

$$\text{CU425,000} * 12.5\% = \text{CU 53,125}$$

TOTAL BORROWING COST TO BE CAPITALISED	
From Specific Borrowing	CU 48,000
From General Borrowing	CU 53,125
Total Borrowing Costs to be Capitalised	CU 101,125