Accounting for Borrowing Cost

Learning Outcomes

At the end of this article you should be able to:

- Identify borrowing costs;
- Identify qualifying assets;
- Distinguish between the borrowing cost to be capitalized and expensed;
- Account for borrowing cost to be capitalized; and
- Apply the disclosure requirements of LKAS 23- *Borrowing costs*.

1.1 Introduction

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs may include interest expense on borrowings such as loans, debentures and overdrafts calculated using the effective interest method and finance charges in respect of finance leases recognized in accordance with LKAS 17 *Leases.*LKAS 23 *Borrowing Costs* addresses accounting for borrowing costs. It considers whether borrowing costs should be capitalised as part of the cost of the asset, or expensed in profit or loss.

1.2 Recognition

LKAS 23 requires that borrowing costs directly attributable to the acquisition, construction or production of a 'qualifying asset' are included in the cost of the asset. All other borrowing costs are expensed as incurred. A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. LKAS 23 does not define 'substantial period of time'. Management exercises judgment when determining which assets are qualifying assets. Examples of qualifying assets include, inventories, manufacturing plants, power generation facilities, intangible assets and investment properties. Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets and also assets that are ready for their intended use or sale when acquired are not qualifying assets.

- ***Borrowing Costs Eligible for Capitalization***

There are two circumstances under which borrowing costs will be eligible for capitalization as indicated below.

a) Where funds are borrowed specifically for the purpose of obtaining a qualifying asset.

   Borrowing costs eligible for capitalization are the actual costs incurred less any income earned on the temporary investment of such borrowings

b) Where funds are borrowed generally and use them for the purpose of obtaining a qualifying asset.

   The eligible amount of borrowing cost for capitalization is determined by applying a capitalization rate to the expenditure on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the general pool of funds that are outstanding during the period

- ***Commencement of capitalization***

Capitalization of borrowing costs should commence when all of the following conditions are satisfied.

   a) it incurs expenditures for the asset;
   b) it incurs borrowing costs; and
   c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

- ***Suspension of capitalization***

Capitalization should be suspended during periods in which active development is interrupted.

- ***Cessation of capitalization***

Capitalization should cease when substantially all of the activities necessary to prepare the asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are outstanding, this indicates that substantially all the activities are complete.

Where construction is completed in stages, parts which 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.

Example 01

Apollo PLC borrowed Rs.1,000,000 loan from bank with an interest rate of 10% which was equal to its effective interest rate on 1 April 2015 for the construction of power generation facilities of the company.

The loan was received on April 01 and utilized Rs. 300,000 on qualifying asset. On April 01, the company deposited the remaining amount in a bank yielding interest at 6% per annum. Whole of the amount is withdrawn and paid to contractor on 31 December 2015 when the construction was completed and ready for use. The company returned the loan to bank on 31 March 2016.Power generation facility was available for use in the business from 1 April 2016.

Required:

1) Calculate the net borrowing cost that should be capitalized 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 2016.
2) Show the extracts from income statement for the year ended 31 March 2016 and Statement of financial position as at 31 March 2016.

Answer

1) The finance cost of the loan must be calculated using the effective rate of 10%, so the total finance cost for the year ended 31 March 2016 is Rs.100,000 (Rs.1 million x 10%). As the loan relates to a qualifying asset, the finance cost (or part of it in this case) can be capitalized under LKAS 23.

   The Standard says that capitalisation commences from when expenditure is being incurred on the asset (1 April 2015) and must cease when the asset is ready for its intended use (31 December 2015); in this case a 9-month period. Thus only nine months of the year's finance cost can be capitalised = Rs.75,000 (Rs.100,000 x 9/12). The remaining three-months finance costs of Rs.25,000 must be expensed. LKAS 23 also says that interest earned from the temporary investment of specific loans should be deducted from the amount of finance costs that can be capitalised. As per the this case, the interest was earned during a period in which the finance costs were being capitalised, thus the interest earned of Rs.31,500 (700,000*.06*9/12) would be credited to the capitalised finance costs. As per LKAS 16, depreciation of the power generation facilities should be started when the asset is available for use which is on 1 April 2016.

2)

Income statement for the year ended 31 March 2016 (Rs'000)		
Finance cost		(25)
Statement of financial position as at 31 March 2016 (Rs'000)		
Property, plant and equipment (cost incurred +finance cost element) (1,000,000+75,000-31,500)		1,043.5

Example 2

Fabric PLC had the following loans outstanding as at 1 April, 2015

	Repayable on	Rs.
Loan 1 at 10%	31 December 2016	500,000
Loan 2 at 6%	31 September 2018	300,000
Loan 3 at 8%	31 March 2017	200,000

The effective interest rates of loans were equal to the coupon interest rates.

The company spent the following amounts on construction of an item of PPE.

	Rs.
1 April 2015	400,000
1 October 2015	300,000
1 January 2016	100,000

As at 31 March 2016 construction was in progress.

Required

1) Capitaization rate
2) Borrowing cost eligible for capitalization
3) Show the extracts from income statement for the year ended 31 March 2016 and Statement of financial position as at 31 March 2016.

Answer

1)

$$Capitalization\ Rate = \frac{Total\ interest}{Weighted\ Average\ Loan}$$

Loans	Outstanding @ 1 April 2015 to 31 March 2016	Weighted Average Loan	Rate	Finance cost
Loan 1	500,000	500,000	10%	50,000
Loan 2	300,000	300,000	6%	18,000
Loan 3	200,000	200,000	8%	16,000
		1,000,000		84,000

$$Capitalization\ Rate = \frac{84{,}000}{1{,}000{,}000} = 8.4\%$$

Note: Only one capitalization rate will be required since no loan repayments take place during the year. Several capitalization rates will be required when there is a change in outstanding loan balances during the year.

2)

Borrowing cost eligible for capitalization	
400,000*8.4%	33,600
300,000* 8.4%*6/12	12,600
100,000*8.4% x 3/12	2,100
	48,300

3)

Income statement for the year ended 31 March 2016 (Rs'000)		
Finance cost	(84,000-48,300)	(35.7)
Statement of financial position as at 31 March 2016 (Rs'000)		
Property, plant and equipment in progress (cost incurred +finance cost element) (800,000+48,300)		848.3
Non-current liabilities		
10% Loan 1		500
6% Loan 2		300
8% Loan 3		200

Examples 3

Amaya PLC obtained Rs.10 million loan with an interest rate of 12% which was equal to its effective interest rate on 1 April 2015. The loan was specifically issued to finance the building of the new store which meets the definition of a qualifying asset in LKAS 23. Construction of the store commenced on 1 May 2015 and it was completed and ready for use on 28 February 2016, but did not open for trading until 1 April 2016. In order to complete the construction company had incurred Rs.12 million. During the year trading at Amaya's other stores was below expectations so Amaya suspended the construction of the new store for a two-month period during July and August 2015. The proceeds of the loan were temporarily invested for the month of April 2015 and earned interest of Rs.50, 000.

Required:

1) Calculate the net borrowing cost that should be capitalized 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 2016.
2) Show the extracts from income statement for the year ended 31 March 2016 and Statement of financial position as at 31 March 2016.

Answer

1) The finance cost of the loan must be calculated using the effective rate of 12%, so the total finance cost for the year ended 31 March 2016 is Rs.1,200,000 (Rs.10 million x 12%). As the loan relates to a qualifying asset, the finance cost (or part of it in this case) can be capitalized under LKAS 23.

   The Standard says that capitalisation commences from when expenditure is being incurred on the asset (1 May 2015) and must cease when the asset is ready for its intended use (28 February 2016); in this case a 10-month period. However, interest cannot be capitalised during a period where development activity is suspended; in this case the two months of July and August 2015. Thus only eight months of the year's finance cost can be capitalised = Rs.800,000 (Rs.1,200,000 x 8/12). The remaining four-months finance costs of Rs.400,000 must be expensed. LKAS 23 also says that interest earned from the temporary investment of specific loans should be deducted from the amount of finance costs that can be capitalised. However, in this case, the interest was earned during a period in which the finance costs were **NOT** being capitalised, thus the interest received of Rs.50,000 would be credited to the income statement and not to the capitalised finance costs.

As per LKAS 16, depreciation of the new shore facilities should be started when the asset is available for use which is on 1 April 2016.

2)

Income statement for the year ended 31 March 2016 (Rs'000)		
Investment income		50
Finance cost		(400)
Statement of financial position as at 31 March 2016 (Rs'000)		
Property, plant and equipment (cost incurred +finance cost element) (12,000,000+800,000)		12,800
Non-current liabilities		
12% Loan		10,000

Example 4

Baxter PLC had the following loans outstanding as at 1 April, 2015

	Repayable on	Rs.
Loan 1 at 6%	31 December 2016	300,000
Loan 2 at 8%	30 September 2015	200,000
Loan 3 at 9%	31 March 2017	100,000

The effective interest rates of loans were equal to the coupon interest rates.

The company spent the following amounts on construction of an item of PPE.

	Rs.
1 April 2015	300,000
1 October 2015	100,000

As at 31 March 2016 construction was in progress.

Required

1) Capitaization rates
2) Borrowing cost eligible for capitalization
3) Show the extracts from income statement for the year ended 31 March 2016 and Statement of financial position as at 31 March 2016.

Answer

1)

$$Capitalization\ Rate = \frac{Total\ interest}{Weighted\ Average\ Loan}$$

Loans	Outstanding @ 1 April 2015 to 31 March 2016	Weighted Average Loan	Rate	Finance cost
Loan 1	300,000	300,000	6%	18,000
Loan 2	200,000 x (6/12)	100,000	8%	8,000
Loan 3	100,000	100000	9%	9,000
		500,000		35,000

$$Capitalization\ Rate = \frac{35{,}000}{500{,}000} = 7\%$$

Loans	Outstanding @ 1 October 2015 to 31 March 2016	Weighted Average Loan	Rate	Finance cost
Loan 1	300,000 x (6/12)	150,000	6%	9,000
Loan 3	100,000 x (6/12)	50,000	9%	4,500
		200,000		13,500

$$Capitalization\ Rate = \frac{13{,}500}{200{,}000} = 6.75\%$$

2)

Borrowing cost eligible for capitalization	
300,000*7%	21,000
100,000* 6.75%*6/12	3,375
	24,375

3)

Income statement for the year ended 31 March 2016 (Rs'000)		
Finance cost	(35,000-24,375)	(10.625)
Statement of financial position as at 31 March 2016 (Rs'000)		
Property, plant and equipment in progress (cost incurred +finance cost element) (400,000+24,375)		424.375
Non-current liabilities		
6% Loan 1		300
9% Loan 3		100

1.3 Disclosures

An entity should 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.

1.4 Summary

The core principle of the standard is that only those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised. All other borrowing costs are expensed as incurred.