# COMMON ERRORS IN APPLYING AASB 123 *BORROWING COSTS*

**AASB 123 *BORROWING COSTS* IS ONLY 15 PAGES LONG AND COMPRISES ONLY 30 PARAGRAPHS.**

Despite its simplicity, some of its principles are counter-intuitive, and there are a number of areas where preparers of financial statements are misinterpreting its requirements, including:

- Failing to capitalise interest
- Commencing capitalisation of interest too early
- Failing to cease capitalisation of interest at the correct point
- Capitalising at a rate that is too high
- Capitalising at a rate that is too low.

### Failing to capitalise interest

The current version of AASB 123 has been in effect since January 2009, however people still hark back to the earlier version which gave companies a choice of whether to capitalise interest or not when a qualifying asset was being constructed. AASB 123, paragraph 8, requires borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset, to be capitalised. There is no choice.

**Paragraph 8**

"An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them."

Another common mistake made by preparers of financial statements is to assume that only specified borrowings must be capitalised. 'Directly attributable' borrowing costs that must be capitalised under paragraph 8 means borrowing costs that would have been avoided if expenditure on the qualifying assets had not been made. **It is therefore not only borrowing costs on specific borrowings that must be capitalised, but in addition, borrowing costs on general borrowings must also be capitalised.**

#### Example 1

Company A is a profitable company with strong operating cash flows. It decides to construct a qualifying asset for $10 million that will take two years to construct. Company A's only borrowings are:

- A $1 million overdraft facility that it uses for working capital purposes
- The debt element on a five year convertible note.

Company A budgets to pay for the asset out of surplus operating cash flows and will not incur any additional borrowings.

The accountant argues that because there are no specific borrowings taken out for the project, there is no interest to capitalise. **WRONG.**

AASB 123, paragraph 11, notes that it may be difficult to identify a relationship between a particular borrowing and a qualifying asset and to determine the amount of borrowings that could otherwise have been avoided. Therefore judgement is required when determining the amount of borrowing costs that are directly attributable to the qualifying asset. AASB 123, paragraph 14, also makes it clear that funds borrowed generally and used for the purpose of obtaining a qualifying asset must be included in the capitalisation rate for borrowing costs capitalised.

Even though Company A might consider that the qualifying asset will be funded from operating cash flows, the fact that Company A has general borrowings means that borrowing costs on these general borrowings must be capitalised. We therefore assume that any funds borrowed generally will firstly be used to fund the qualifying asset, and then be used for working capital needs, even if the cash flows from operating activities are enough to finance the qualifying asset.

The borrowing costs on the overdraft and the convertible note must therefore be included in determining the amount of interest to be capitalised because they form part of general borrowings of the entity.

#### Example 2

Company B decides to construct a qualifying asset for $10 million that will take two years to construct. Company B has an existing bank loan of $10 million and determines that the construction of the asset will be funded by way of a capital raising.

The accountant argues that because there are no specific borrowings taken out for the project, then there is no interest to capitalise.
**WRONG.**

Similar to the explanation provided in Example 1 above, general borrowings are firstly assumed to fund the qualifying asset, and then operating cash flows. The fact that Company B will undertake a capital raising is irrelevant. The borrowing costs on the existing $10 million must be included in determining the amount of interest to be capitalised.

Note: If the Company B had no borrowings at all, but undertook a $10 million capital raising to fund the construction of the qualifying asset, Company B would not be permitted to capitalise a deemed or notional interest charge.

#### Example 3

Company C decides to construct a qualifying asset for $10 million that will take two years to construct. Company C has an existing bank loan of $10 million which was taken out four years ago to specifically fund the construction of its new head office (a qualifying asset). Company C applied AASB 123 to the construction of the new head office, which was completed two years ago. The construction of the new qualifying asset will be funded by way of a capital raising.

The accountant argues that there are no borrowings to be capitalised because the only loan was taken out for another specified project.
**IT DEPENDS.**

There are different views about whether the original $10 million loan to build the new head office stays as a specific borrowing, or can change its nature into a general borrowing. These include:

- Once identified as a specific borrowing, the loan will remain a specific borrowing until it is settled
- Once the qualifying asset (head office) has been completed, the loan becomes part of general borrowings if the entity chooses not to settle the loan.

If the qualifying asset was, for example, an investment property, and the loan contract specified that Company C must settle the loan out of proceeds of operating/selling the investment property, there is also a view that the borrowings could remain as specific borrowings.

In our view, based on the facts presented in this example, the borrowing costs on the existing $10 million must be included in determining amounts to be capitalised because the asset to which the loan originally related (head office) has been completed, i.e. becomes part of general borrowings.

### Example 4

Company D decides to construct a qualifying asset for $10 million that will take two years to construct. At the time it enters into the construction contract, Company D has no borrowings and elects to fund the project through working capital and an equity raising. Three months after construction starts, Company D purchases Company E, and funds the acquisition partly through $5 million of long term bank debt.

The accountant argues that there are no borrowings to be capitalised because the only loan was taken out for another specified project (i.e. purchase of Company E). **WRONG.**

In 2009, the Interpretations Committee considered the issue of whether funds borrowed for a specific asset, that is not a qualifying asset, could be excluded from general borrowings when determining the amount of borrowing costs to be capitalised on qualifying assets. The Interpretations Committee did not issue an Interpretation on this question, but passed it onto the International Accounting Standards Board (IASB) to consider for annual improvement.

The IASB did not make an annual improvement because they concluded that funds borrowed specifically for a non-qualifying asset must be included as part of general borrowings because AASB 123, paragraph 14, only excludes debt on **qualifying assets**.

Therefore, the borrowing costs on the new $5 million loan to finance a non-qualifying asset (Investment in Company E) must be included in determining amounts to be capitalised.

## Commencing capitalisation of interest too early

AASB 123 only permits capitalisation of borrowing costs when the qualifying asset is being constructed. In many cases, the purchaser pays the manufacturer to construct the asset offsite (e.g. aircraft, ships, oil rigs, etc.). This will typically involve the purchaser paying a deposit or mobilisation fee before construction commences.

### Example 5

Company E orders the construction of three oil rigs. On 1 January 2013 it pays a $15 million deposit to secure production of the three rigs over the coming year ($5 million for each rig). Rig construction will commence on 1 April 2013 for the first rig, and the second and third rigs will start construction on 1 June 2013 and 31 October 2013 respectively. The project is funded by specific borrowings which are initially advanced on 1 January 2013.

The accountant proposes that interest should be capitalised on the whole $15 million from 1 January 2013. **WRONG.**

AASB 123, paragraph 17 requires that capitalisation of interest can only commence when all of the following three conditions have been met:

- Expenditure has been incurred on the asset
- Borrowing costs have been incurred on the asset
- Activities have been undertaken that are necessary to prepare the asset for its intended use or sale.

Activities undertaken to prepare the asset for its intended use or sale include physical construction of the asset, and some technical and administrative work prior to commencing construction. In this case, capitalisation can only commence when construction commences because there is no technical or administrative work necessary prior to construction of the rigs (e.g. obtaining permits prior to physical construction), so capitalisation of interest on $5 million for Rig 1 should commence 1 April 2013, Rig 2 on 1 June 2013 and Rig 3 on 31 October 2013.

## Failing to cease capitalisation of interest at the correct point

Failing to cease capitalising interest at the appropriate point is a common error when applying AASB 123. This typically arises when:

- The asset is complete but is not yet being used or there has been a delay in selling the asset, or
- The asset is not being actively developed.

**Extracts from AASB 123:**

**Paragraph 22**

"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."

**Paragraph 24**

"When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale."

### Example 6

Entity Z is constructing a new factory complex which comprises a number of elements. Construction commences on 1 January 2013, and the factory will commence manufacturing in August 2014. The whole site, including administration and research facilities will be completed by June 2015.

| BUILDING | DATE COMPLETED |
|---|---|
| Raw materials warehouse | November 2013 |
| Main production facility | July 2014 |
| Finished goods warehouse | October 2014 |
| Administration block | May 2015 |
| R&D facility | June 2015 |

The accountant proposes that interest should be capitalised on the whole capital expenditure up to 30 June 2015 when the factory site is completed. **WRONG.**

Capitalisation can only take place when the asset is being developed. In this example, capitalisation of borrowings in respect of the costs associated with the raw materials warehouse should cease in November 2013, capitalisation of borrowings in respect of costs associated with the main production facility should cease in July 2014, etc.

### Example 7

Company F is constructing an amusement park. The park is completed ahead of schedule on 30 April 2013. However, it will not be open to the public until the start of the tourist season on 1 October 2013.

The accountant proposes that capitalisation of interest should cease on 30 September 2013. **WRONG.**

Capitalisation of interest should cease on 30 April 2013 when the asset is completed, not when the asset starts being used.

### Example 8

Company G constructs an apartment building comprising 20 units. The building is completed on 30 April 2013. Unfortunately only 10 of the 20 units have been sold at that point, so the interior of the unsold 10 apartments (kitchen units, bathroom fittings, etc.) will not be installed until a buyer has been found and chosen the interior specifications.

The accountant proposes that interest should continue being capitalised until all units have been completed. **WRONG.**

Capitalisation should cease on 30 April 2013 when the asset is substantially completed.

### Example 9

Company H is a property developer. It buys a parcel of agricultural land for development on 1 April 2013 and immediately submits plans to the local planning authority for a high density housing project. On 1 August 2013 there is a change of government to a party that is committed to protect the rural environment and to stop 'urban sprawl'. The planning application is officially rejected on 31 October 2013. Expert advice says that it is unlikely that this ruling can be overturned without a change of government.

The accountant proposes that interest should continue being capitalised as the company intends to eventually develop the land. **WRONG.**

Capitalisation should cease on 1 August 2013.

### Capitalising at a rate that is too high

Common errors where interest is capitalised at a rate that is too high include:

- Ignoring interest income on deposits of monies drawn down on specific borrowings intended to fund a qualifying asset
- Capitalising loan arrangement fees into the project rather than accounting for them using the effective interest rate method
- Omitting low interest borrowings from the capitalisation calculation.

A common application issue when applying AASB 123 to projects that are funded by specific borrowings is that the loan is drawn down immediately at the commencement of the project and the proceeds are placed on deposit.

### Example 10

Company J is to construct a qualifying asset that will cost $100 million and will take three years to complete. Company J funds this by way of a $100 million loan. The loan incurs 10% interest and is drawn down on 1 January 2013 and placed on deposit paying 5% interest. The first spend on construction was on 1 April 2013 for $10 million, which funded construction up to 30 June 2013.

The accountant proposes that the interest to be capitalised is $5 million, being six months' interest on the specified borrowings (10%*$100m *6/12). **WRONG.**

The proposal is incorrect for three reasons:

- Capitalisation of borrowings should only commence from the point that construction commences (i.e. 1 April 2013)
- Interest should only be capitalised to the extent that costs have been incurred, therefore borrowing costs should only be capitalised on the $10 million actually spent
- The interest income on monies on deposit from the specific borrowings should be offset against the interest capitalised.

Therefore the amount that should be capitalised is $1.25 million ($10m*5%*3/12).

### Capitalising at a rate that is too low

There are a number of common mistakes made that can understate the interest rate used for capitalising interest. These include:

- Offsetting deposit income where no specific borrowings have been identified
- Using the coupon rate rather than the effective interest rate
- Omitting high interest borrowings from the capitalisation calculation.