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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

CL 02 – Financial Reporting and Governance

Corporate Level

(LKAS 23)

Chandima Prabhath

B.Sc. Accounting (special) USJ (UG) | CA Passed Finalist | CMA Passed Finalist | AAT Passed Finalist | ICAEW Finalist | CA, CMA and AAT Merit and Subject Prize winner | Certification in Forensic Accounting (CASL)

LKAS 23 – Borrowing Costs

Topic No 05

Core Principle

Borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset form **part of the cost** of that asset. **Other** borrowing costs are recognised as an **expense**.

Scope (Important)

An entity shall apply this Standard in accounting for borrowing costs. The standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

Not required to apply the Standard:
• a qualifying asset measured at fair value, for example a biological asset within the scope of LKAS 41 Agriculture • inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis

Definitions

Borrowing costs	Interest and other costs that an entity incurs in connection with the borrowing of funds.
Qualifying asset	Asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing Cost Includes

- Interest expense calculated using the effective interest method as described in SLFRS 9
- Interest in respect of lease liabilities recognized in accordance with SLFRS 16 Leases
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Qualifying Asset might include

- Inventories *(Ex- Air crafts)*
- Power generation facilities
- Investment properties
- Manufacturing plants
- Intangible assets *(Ex – Software)*
- Bearer plants

Below are not Qualifying Assets

1. **Financial assets**, and
2. Inventories that are manufactured, or otherwise produced, over a **short period of time.**
3. Assets that are **ready for their intended use or sale when acquired** are not qualifying assets.

Question 01 – Qualifying Assets

State which assets can be considered as qualifying assets.

Asset	Description	Yes/No
Manufacturing Plant	It will take 02 years to complete the construction.	
Power Generation Facility	It will take 04 years to complete the construction.	
Office Building	It is expected to upgrade (taking 1.5 years) and rent out to a 3rd party	
Orange Juice	The production process will take five hours	
Wine	It will take 10 years to mature	
Inventory of a wholesaler	These goods will be sold without changing their original condition	
Building	It is available for use at the time of acquisition	

Recognition

Borrowing Costs

Directly attributable to the acquisition, construction or production of a qualifying asset	Other borrowing costs
Capitalize → Recognize as a part of the cost of the asset	Recognize as an **expense** in the period in which it incurs

- Directly attributable 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.
- When an entity applies LKAS 29 Financial Reporting in Hyperinflationary Economies, it recognizes as an expense the part of borrowing costs that compensates for inflation during the same period.

Borrowing costs eligible for capitalization

Type of borrowing	Specific Borrowings	General Borrowings
Borrowing costs eligible for capitalizations	Actual borrowing costs incurred on that borrowing during the Period less any investment income on the temporary investment of those borrowings	Calculated by applying a capitalizations rate to the expenditures on that asset (Capitalization rate * Expenditure incurred on that asset)

- An entity shall **exclude** from this calculation borrowing costs applicable to borrowings made specifically *(specific borrowings)* for the purpose of obtaining qualifying asset.
- The amount of borrowing costs that an entity capitalizes during a period shall not exceed the amount of borrowing costs it incurred during that period.

Calculation of capitalization rate

- The capitalization rate shall be the **weighted average of the borrowing costs** applicable to all borrowings of the entity that are **outstanding during the period**.

Question 02 – Specific Borrowings

Apex issued a Rs. 10 million unsecured loan with a coupon (nominal) interest rate of 6% on 1 April 2018. The loan is redeemable at a premium which means the loan has an effective finance cost of 7.5% per annum. 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 2018, and it was completed and ready for use on 28 February 2019 but did not open for trading until 1 April 2019. The proceeds of the loan were temporarily invested for the month of April 2018 and earned interest of Rs. 40,000.

Required:

Prepare a schedule showing 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 profit or loss for the year ended 31 March 2019.

Question 03 – Capitalization rate

An entity has two outstanding items of debt during the year ended 31 December 2023.

- Rs. 80m bank loan with an interest rate of 7% (Obtained on 01.07.2023)
- Rs. 100m loan notes with an interest rate of 9%

Neither has been obtained for a specific purpose.

Required:

Calculate the capitalization rate to be applied to expenditure on qualifying assets funded using these general borrowings.

Commencement, suspension and cessation of capitalization

Commencement	Suspension	Cessation
Shall **begin** to capitalize on the **commencement date**. Commencement date is the **first date** that meet all following conditions. 1. it incurs expenditures for the asset 2. it incurs borrowing costs 3. it undertakes activities that are necessary to prepare the asset for its intended use or sale	An entity shall **suspend capitalization** of borrowing costs during extended periods in which it suspends active development of a qualifying asset. Have to consider the impact to the development period of the qualifying asset ***(Materiality of the event)***	Shall **cease capitalizing** borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. When the construction of a qualifying asset is completed in parts where each part is capable of being used while construction continues other parts, the entity shall cease capitalizing borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

Commencement date criteria in detail

1. **It incurs expenditures for the asset**
   a. Include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities.

b. Expenditures are reduced by any progress payments received and grants received in connection with the asset.
c. The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditures to which the capitalization rate is applied in that period.

2. It undertakes activities that are necessary to prepare the asset for its intended use or sale

a. Those are not limited to the physical construction of the asset.
b. Can **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.
c. However, it **excludes** holding of an asset when no production or development that changes the asset's condition is taking place.
d. Ex:

Borrowing costs incurred while land is under development	**Capitalized**
Borrowing costs incurred while land acquired for building purposes is held without any Associated development activity	**Cannot be capitalized.**

Question 04 - Commencement

Based on the information below, identify from which date the entity should commence capitalization.

1. On 01.01.2021 the plan of the building was passed.
2. On 25.02.2021 the company borrowed Rs.10 Mn to construct a building.
3. On 01.03.2021 construction was started, and an initial amount was paid to the contractor.

Temporary suspension in detail

- When an entity suspends activities in an extended period costs incurred in hat extended periods are costs of holding partially completed assets and do not qualify for capitalization.

- However, an entity does not normally suspend capitalizing borrowing costs during a period when it carries out substantial technical and administrative work.

- Further, an entity also does not suspend capitalizing borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

    - Example - capitalization continues during the extended period that high water levels delay construction of a bridge, if such high-water levels are common during the construction period in the geographical region involved.

Question 05 – Suspension

In each below incident identify whether to suspend the capitalization or not with reasons in line with LKAS 23.

1. Workers go on strike
2. A delay due to a damage by fire
3. Factory closed down during a holiday season
4. The production process is slow

Cessation of capitalization in detail

- 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.
    - For example, minor modifications, such as the decoration of a property to the purchaser's or user's specification, are the only outstanding activities, this indicates that substantially all the activities are complete.

Disclosures

An entity shall disclose:
1. The amount of borrowing costs capitalized during the period; and
2. The capitalization rate used to determine the amount of borrowing costs eligible for capitalization

Please note that the disclosure requirements are continuously changing and updating. Therefore, referring to the standard is important for disclosures.

Question 06 – December 2022

The CEO provided the following information about the financing of the theme park construction through a special loan and also from the available overdraft facilities of the company.

On 31 August 2021, THP entered into a Rs. 500 million contract with THC Construction (Pvt) Ltd (THC) for the construction of the theme park. Construction is to be completed by 31 December 2024. Payments to be made to THC, are given below.

Payment date	9/30/202	3/31/202	9/30/202	3/31/202	7/31/202
Amount (Rs. Mn)	50	125	125	125	75

Managing Director of THC is the independent non-executive Chairman of THP.

- Help Bank PLC (Help Bank) agreed to grant a 5-year loan amounting to Rs. 300 million to finance 1st, 2nd and 3rd payments to the contractor at a fixed interest rate of 10% p.a. The loan was released as follows.
    - 1 st tranche on 30 September 2021: Rs. 175 million
    - 2 nd tranche on 30 September 2022: Rs. 125 million

  Help Bank indicated that an interest income of Rs. 200,000 could be earned on the above funds while they are held in a bank account in anticipation of payments.
- Loan repayment - 30 January 2025 to 31 August 2026 at Rs. 15 million per month
- Interest on the loan will be recovered by the bank from the company on a monthly basis from 30 October 2021.

The company's **general borrowings** are as follows.

1. Alpha Bank permanent overdraft (POD) facility of Rs. 400 million Interest at 15% p.a on the utilized balance at the end of each month. The Treasury division of THP ensures that the POD amount does not exceed Rs. 300 million at the end of each month.
2. Beta Bank temporary overdraft (TOD) facility of Rs. 200 million the interest rate is 12% p.a. The company fully utilizes this facility at the end of each month for its funding requirements.

Required:

(a) Determine the application of LKAS 23 Borrowing Costs to the above transactions and provide the necessary calculations only up to 31 December 2024.

Question 07 – December 2022

On 1 October 2022 HN obtained a loan of Rs. 200 million to partially finance the construction of a new office building. No repayments were made during the period from 1 October 2022 to 31 March 2023. The remaining cost will be self-funded by HN. This loan has an effective interest rate of 10% p.a. On 1 January 2023, the company paid its first construction payment of Rs. 200 million to purchase construction material, and the construction activities commenced on the same day.

Required:

(a) Apply LKAS 23 Borrowing costs for the situation referred to in (iv) above by providing guidance on the following.
   a. When the capitalization should commence.
   b. The amount that should be capitalized as borrowing costs for the year ended 31 March 2023.

Question 08 – December 2020

IPL purchased a land to construct an apartment complex on 1 January 2018 for Rs. 30 million. The company spent two months on planning activities and on 1 March 2018 the planning approvals were obtained. The development of the land was also completed on this date and construction commenced immediately after obtaining the approvals. The estimated cost of construction was Rs. 150 million. Construction was temporary suspended due to COVID-19 from 11 March 2020 to 10 May 2020. On 30 September 2020 the apartment complex was ready for sale except for a few modifications in some units to suit buyers' specifications. All these modifications were completed on 15 October 2020.

IPL made the following payments to the contractor.

Phase	Date of payment	Amount (Rs. million)
Phase 1	3/1/2018	40
	1/1/2019	30
Phase 2	8/1/2019	20
	12/31/2019	30
Phase 3	6/30/2020	20
	9/30/2020	10
Total payment		**150**

The following information is related to IPL's borrowings.

a. On 1 January 2018, IPL obtained a loan of Rs. 100 million specifically for the apartment complex project at an annual interest rate of 14%, which is equivalent to the effective interest rate (EIR). The loan is repayable over 5 years at an annual amount of Rs. 29 million. IPL earned interest income of Rs.

1.7 million by temporary investing the funds until payments were made to the contractor.

b. Phase 2 and Phase 3 of construction were financed by IPL's existing borrowings. Details of the existing borrowings of the company during the construction period are given below.

- A loan obtained at 12% p.a. had an outstanding amount of Rs. 20 million as of 1 August 2019. This loan was fully repaid on 1 October 2020.
- Debentures issued at 13% p.a. had an outstanding amount of Rs. 35 million as at 1 August 2019 and this remained unchanged as at 15 October 2020.
- A loan obtained at 11% p.a. had an outstanding balance of Rs. 50 million as at 1 August 2019. This amount was fully settled on 15 November 2020

Required:

(a) Advise the management of IPL on the borrowing costs that should be capitalized to the apartment complex according to the requirements of LKAS 23 Borrowing Costs. *(Assume that the amount of borrowing costs capitalized during a period does not exceed the amount of borrowing costs incurred during the period.)*