This article aims to:
- Discuss key issues with respect to accounting of borrowing costs under Ind AS.
Introduction

Currently, Indian Accounting Standard (Ind AS) 23, Borrowing Costs governs the principles relating to accounting of borrowing costs. As per the standard, an entity is required to 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.

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. In certain cases, determination of such directly attributable costs is difficult and requires exercise of judgement. For instance, financing activity of an entity is coordinated centrally or a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group.

Capitalisation of borrowing costs would commence when an entity meets all of the following conditions:

a. Expenditure for the asset is being incurred
b. Borrowing costs are being incurred and
c. Activities that are necessary to prepare the asset for its intended use or sale are in progress.

Capitalisation of borrowing costs is suspended during the period in which active development of a qualifying asset itself is suspended and altogether ceased when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

The guidance in Ind AS 23 is largely similar to the guidance prescribed under International Accounting Standard (IAS) 23, Borrowing Costs issued by the International Accounting Standard Board (IASB). Ind AS 23 additionally, provides guidance on how the adjustment on account of foreign exchange differences is to be determined which is not present in IAS 23.

In this article, we aim to highlight certain key areas relating to borrowing costs.

Issue 1: Qualifying asset is ready for intended use - specific borrowing considered as general borrowing

As per the standard, to the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity is required to determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period, excluding borrowings made specifically for the purpose of qualifying asset.

There has been a debate in the past as to whether borrowings made specifically for the purpose of a qualifying asset can be considered as part of general borrowings once the qualifying asset is ready for its intended use. In the absence of any guidance, there has been diversity in practice in such cases.

In this regard, the Expert Advisory Committee (EAC) (the committee) of the Institute of Chartered Accountants of India (ICAI) in a given case study (based on Accounting Standard (AS) 16, Borrowing Costs) highlighted that while determining which borrowings should be considered for application of the capitalisation rate to be applied to general borrowings, an entity should exclude those borrowings which were borrowed for a specific purpose unless there is an evidence that the same were used for the capital expenditure on qualifying assets.

Therefore, under AS, even if an asset is ready for its intended use, specific borrowings in relation to a qualifying asset that would be outstanding were not considered as part of general borrowings.

On the other hand, as per US Generally Accepted Accounting Principles (GAAP), money is considered to be fungible and therefore, attributing an expenditure to a particular source of funds is considered impracticable since the funds from various sources get pooled together. Even where such attribution is practicable, the resultant identification could be arbitrary. For instance, a payment for a qualifying asset made from a bank account wherein funds raised from equity alone have been placed may as well could have been made from a different bank account.

The International Financial Reporting Standards (IFRS) also carries the same analogy as that of US GAAP, however, it was not clearly mentioned that specific borrowing should be considered as part of general borrowings, once the qualifying asset is available for intended use.

Recently, as part of the annual improvements to IFRS, on 12 December 2017, the IASB amended IAS 23 and clarified that while computing the capitalisation rate for funds borrowed generally, an entity should exclude borrowing costs applicable to borrowings made specifically for obtaining a qualifying asset, only until the asset is ready for its intended use or sale.
Borrowing costs related to specific borrowings that remain outstanding after the related qualifying asset is ready for intended use or for sale would subsequently be considered as part of the general borrowing costs of the entity.

The standard also clarifies that an entity includes funds borrowed specifically to obtain an asset other than a qualifying asset as part of general borrowings.

Similar amendment has been made in Ind AS 23 which is applicable to borrowing costs incurred on or after the beginning of the annual reporting period beginning on or after 1 April 2019.

**Issue 2: Eligible amount of borrowing costs for the purpose of capitalisation**

The IFRS Interpretations Committee (IFRIC) (the committee) of IASB in its update issued in September 2018 considered a case where an entity incurs expenditure on the qualifying asset both before and after it incurs borrowing costs on the general borrowings.

As per the facts of the case, the entity did not incur any borrowings at the start of the construction of the qualifying asset. However, during the course of construction, the entity borrowed funds generally and used them to finance the construction of the qualifying asset. The issue under consideration was whether the entity is allowed to use the expenditure on the qualifying asset incurred before obtaining general borrowings while determining the amount of borrowing costs eligible for capitalisation.

Based on the guidance given in IAS 23, the IASB in this case, concluded that an entity would not begin capitalising borrowing costs until it incurs borrowing costs.

Once the entity incurs borrowing costs and therefore, satisfies all the three conditions given in the standard for capitalisation (i.e. incurs expenditure on the asset and borrowing costs and undertakes activities that are necessary to prepare the asset for its intended use or sale) then it is required to apply the standard to determine the expenditures on the qualifying asset to which it applies the capitalisation rate.

The committee observed while determining the expenditure on qualifying asset to which an entity applies capitalisation rate, it should not disregard expenditure on the qualifying asset incurred before it obtains the general borrowings.

**Issue 3: Application of capitalisation rate for assets acquired under business combination**

Another area of concern relates to treatment of borrowing costs (eligible for capitalisation) acquired as part of a business combination in the separate and the Consolidated Financial Statements (CFS) of an entity.

With a view to provide some guidance in the area, the Ind AS Technical Facilitation Group (ITFG) of ICAI in its bulletin 19 (issue 4) dated 10 May 2019 considered a situation where a company (ABC Ltd.) has a Capital Work in Progress (CWIP) of INR100,000 which meets the definition of a ‘qualifying asset’ as per Ind AS 23 and capitalised corresponding borrowing cost using capitalisation rate for general borrowings.

The issue relates to what would be the accounting treatment of borrowing cost in case:

- PQR Ltd., an independent entity, acquires ABC Ltd. and merges it into itself.
- PQR Ltd. acquires 100 per cent shares and control of ABC Ltd. but ABC Ltd. remains a separate legal entity consolidated by PQR Ltd.

ITFG provided following guidance in the above mentioned situations:

**Situation 1:** Where ABC Ltd. is merged into PQR Ltd. and merger meets the definition of a ‘business combination’ as per Ind AS 103, *Business Combination*, the CWIP would appear as an asset in the separate and consequently, in the CFS of PQR Ltd. At the time of merger, PQR Ltd. needs to make a fresh, independent assessment to evaluate whether CWIP meets the definition of a qualifying asset from its perspective.

In the given case, PQR Ltd. made an independent assessment and asserted that the CWIP still meets the definition of a qualifying asset and attributed an amount of INR120,000 as a consideration towards purchase of the CWIP as part of the purchase price.

The value of CWIP and timing of incurrence of the aforesaid expenditure should be determined from the perspective of PQR Ltd. and not from the perspective of ABC Ltd. For instance, if PQR Ltd. acquires ABC Ltd. and pays cash consideration on 1 July 20XX, then, for determining the amount of borrowing costs to be capitalised, the expenditure of INR120,000 would be considered to have been incurred by PQR Ltd. on 1 July 20XX.
Consequently in separate and CFS of PQR Ltd., INR120,000 would represent the expenditure incurred by PQR Ltd. on the CWIP and for purposes of applying the requirements of Ind AS 23 relating to capitalisation of borrowing costs.

**Situation 2:** Instead of a merger, in case PQR Ltd. acquires 100 per cent shares and consequently control of ABC Ltd. which continues to remain in existence, PQR Ltd.'s CFS would include the CWIP as an asset but not in its separate financial statements. For the purpose of CFS, the determination of whether an asset meets the definition of a ‘qualifying asset’ and the amount of expenditure incurred thereon would be made from the perspective of the group rather than from the perspective of the subsidiary which owns or holds the CWIP.

In the issue under consideration, the group has incurred an expenditure of INR120,000 to acquire the CWIP from a party outside the group. For the purpose of applying the requirements of Ind AS 23 relating to capitalisation of borrowing costs at the group level, it is determined that the CWIP meets the definition of a ‘qualifying asset’ from the group’s perspective and the amount of expenditure on the CWIP would be considered to be INR120,000.

Accordingly, the separate financial statements of PQR Ltd. would include the investment in ABC Ltd. rather than individual assets and liabilities of ABC Ltd. As this investment is a financial asset, borrowing costs cannot be capitalised as part of carrying amount as per the requirements of Ind AS 23 which specifically provides that financial assets are not qualifying assets.

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**Consider this...**

- An entity would not begin capitalising borrowing costs until it incurs borrowing costs.
- Capitalisation of borrowing costs will commence when an entity meets all the given conditions:
  - a. It incurs expenditure 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.

Once all the above conditions are met, the entity has to apply the standard to determine the expenditures on the qualifying asset to which it applies the capitalisation rate.

- An entity would be required to exclude borrowing costs applicable to borrowings made specifically for obtaining a qualifying asset, only until the asset is ready for its intended use or sale.