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In depth

A look at current financial reporting issues

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IAS 23 - Capitalisation of borrowing costs

At a glance

IAS 23, 'Capitalisation of borrowing costs', is one of the shortest standards in IFRS. It has remained virtually unchanged since 1993, except that the option to expense borrowing costs related to acquisition or construction of qualifying assets was eliminated in 2009. However, practical implementation of this seemingly simple standard often raises questions for which the standard does not give clear answers.

Challenges include specific versus general borrowings, when to start capitalisation, total borrowing costs eligible for capitalisation, and whether foreign exchange differences should be capitalised. These practical challenges are the focus of this publication.

1. Core principle and definitions

The core principle of IAS 23 is simple: borrowing costs that are directly attributable to the acquisition or construction of a qualifying asset must be capitalised. All other borrowing costs should be expensed.

There are only two defined terms in IAS 23: 'borrowing costs' and 'qualifying asset'.

Borrowing costs are 'interest and other costs that an entity incurs in connection with the borrowing of funds'.

A qualifying asset is defined as 'an asset that necessarily takes a substantial period of time to get ready for its intended use or sale'. Examples of qualifying assets are manufacturing plants, real estate, and infrastructure assets such as bridges and railways.

The standard is not mandatory for assets measured at fair value, such as biological assets and investment property. It also excludes from its scope inventories manufactured in large quantities on a repetitive basis. However, an entity can choose to capitalise borrowing costs on types of assets that are outside the scope of the standard.

In the next sections, we consider application issues that we have observed in practice and specific questions related to various elements of IAS 23.

This publication looks at some of the practical questions that have been raised about how to apply IAS 23. It is intended to be guidance on how to apply the standard, not to create a subset of additional rules. Entities should consider the full text of the standards, consult with their auditors and apply professional judgement to their specific accounting questions.



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2. Qualifying assets

One of the three conditions that must be met before capitalisation of borrowing costs starts is that an entity incurs expenditures for the qualifying asset. Assets that are ready for their intended use or sale when acquired are not qualifying assets, as the asset must require a substantial period of time to get ready for its use or sale. The standard does not define ‘substantial’ and a benchmark of 12 months is often used, but a shorter period might be justified as well.

We consider below some frequently asked questions about qualifying assets.

2.1 *Is there a rule for determining the ‘substantial period of time’?*

No. IAS 23 does not define ‘substantial period of time’. Management exercises judgement when determining which assets are qualifying assets, taking into account, among other factors, the nature of the asset. An asset that normally takes more than a year to be ready for use will usually be a qualifying asset. Once management chooses the criteria and types of asset, it applies this consistently to those types of asset.

2.2 *Can borrowing costs incurred to finance the production of inventories that have a long production period, like wine or cheese, be capitalised?*

Yes. IAS 23 does not require the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis. Interest capitalisation is, however, permitted as long as the production cycle takes a ‘substantial period of time’, as with wine or cheese. The choice to capitalise borrowing costs on those inventories is an accounting policy choice.

2.3 *Can an intangible asset be a ‘qualifying asset’ under IAS 23?*

Yes. An intangible asset that takes a substantial period of time to get ready for its intended use or sale is a ‘qualifying asset’. This would be the case for an internally generated intangible asset in the development phase when it takes a ‘substantial period of time’ to complete, such as software. The interest capitalisation rate is applied only to costs that themselves have been capitalised.

2.4 *Is management intention taken into account when assessing whether an asset is a qualifying asset?*

Yes. Management should assess whether an asset, at the date of acquisition, is ‘ready for its intended use or sale’. The asset might be a qualifying asset, depending on how management intends to use it. For example, when an acquired asset can only be used in combination with a larger group of fixed assets or was acquired specifically for the construction of one specific qualifying asset, the assessment of whether the acquired asset is a qualifying asset is made on a combined basis.

Illustrative example – A telecom licence

Facts:

A telecom company has acquired a 3G licence. The licence could be sold or licensed to a third party. However, management intends to use it to operate a wireless network. Development of the network starts when the licence is acquired.

Question:

Should borrowing costs on the acquisition of the 3G licence be capitalised until the network is ready for its intended use?

Solution:

Yes. The licence has been exclusively acquired to operate the wireless network. The fact that the licence can be used or licensed to a third party is irrelevant. The acquisition of the licence is the first step in a wider investment project (developing the network). It is part of the network investment, which meets the definition of a qualifying asset under IAS 23.

Illustrative example – Acquisition of a permit and equipment

Facts:

A real estate company has incurred expenses for the acquisition of a permit allowing the construction of a building. It has also acquired equipment that will be used for the construction of various buildings.

Question:

Can borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete?

Solution:

Yes for the permit, which is specific to one building. It is the first step in a wider investment project. It is part of the construction cost of the building, which meets the definition of a qualifying asset.

No for the equipment, which will be used for other construction projects. It is ready for its 'intended use' at the acquisition date. It does not meet the definition of a qualifying asset.

2.5 *In a service concession arrangement, should an operator capitalise borrowing costs incurred when constructing or upgrading an infrastructure asset?*

Service concession arrangements are accounted for under IFRIC 12. The consideration received in exchange for the construction or upgrade services is recognised at its fair value either as a financial asset or an intangible asset depending on the terms of the agreement.

An operator that recognises an intangible asset capitalises the associated borrowing costs incurred during the construction phase. However, an operator that recognises a financial asset expenses borrowing costs as incurred.

2.6 *Property under construction or development for future use as an investment property should be measured at fair value during the construction period, if fair value is the accounting policy of the entity for investment property. Can borrowing costs attributable to investment property measured at fair value be capitalised?*

Yes. IAS 23 does not require the capitalisation of borrowing costs for assets measured at fair value as, on a net basis, the carrying amount of the asset would not be affected. But management can still elect to capitalise those borrowing costs. An entity that elects to do so reduces its interest expense incurred during the period by the amount of borrowing costs capitalised and adjusts the carrying amount of the investment property accordingly. Remeasurement of the investment property to fair value has a direct effect on the gain or loss arising from a change in the fair value of investment property recorded in profit or loss for the period.

3. Borrowing costs

The standard has specific requirements for determining borrowing costs eligible for capitalisation for specific borrowings and general borrowings. Specific borrowings are funds borrowed specifically for the purpose of obtaining a qualifying asset. For specific borrowings, the actual costs incurred are capitalised. If the entity temporarily reinvests some funds, investment income earned should be deducted from the borrowing costs eligible for capitalisation.

All borrowings that are not specific represent general borrowings. Costs eligible for capitalisation are calculated by applying a capitalisation rate to the expenditures on qualifying assets. The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period. The amount of borrowing costs eligible for capitalisation is always limited to the amount of actual borrowing costs incurred during the period.

3.1 Is dividend on preferred shares capitalised as borrowing costs?

The treatment of dividends depends on classification of preferred shares. When preferred shares are classified as a liability, dividends in substance represent interest costs and are included in borrowing costs. For preferred shares classified as equity, dividends are not included in borrowing costs.

3.2 Is accretion of interest on decommissioning obligations and other types of provisions capitalised as borrowing costs?

Accretion of interest on decommissioning obligations item is excluded from borrowing costs. Paragraph 8 of IFRIC 1 specifically states that capitalisation of accretion of interest on decommissioning obligations under IAS 23 is not allowed.

Accretion of interest on other types of provisions, although not mentioned specifically in IAS 23, is generally excluded from borrowing costs. Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. Accretion of interest on provisions created based on requirements of IAS 37, 'Provisions, Contingent Liabilities and Contingent Assets', does not meet the definition of borrowing costs.

3.3 A subsidiary obtained an interest-free loan from its parent and used it for the construction of a qualifying asset. Is the accretion of interest capitalised as borrowing costs in the subsidiary's separate financial statements?

The liability is initially recognised at fair value according to IAS 39. The subsidiary has an accounting policy choice regarding how to account for the difference between the fair value of the loan and the amount of funds received from the parent. This difference could be treated either as an addition to the subsidiary's equity or as income in the income statement. This should reflect the economic substance of the transaction. When treated as income, it does not represent a reduction of borrowing costs.

The liability is subsequently measured at amortised cost, with interest accrued using the effective interest rate method. The interest determined using the effective interest method is an element of the borrowing costs and is considered for determining the costs eligible for capitalisation.

3.4 *Are the effects of a cash flow or fair value hedging relationship on interest for a specific project borrowing capitalised?*

Yes. The standard does not address whether the effects of hedging should be capitalised. [IAS 23 para BC21]. However, the purpose of an IAS 39 hedging relationship is to modify the borrowing costs of the entity related to a specific loan. We therefore believe that entities should capitalise interest on borrowings in an IAS 39 designated hedging relationship after taking into account the effects of hedge accounting. The same treatment applies under IFRS 9.

Ineffectiveness on such hedging relationships should continue to be recognised in profit or loss.

3.5 *Is it appropriate to capitalise gains and losses on derivative instruments (for example, interest rate swaps and foreign currency swaps) that have not been designated in a hedging relationship under IAS 39?*

No. Such instruments fall under the category 'fair value through profit or loss'. As they have not been linked to borrowing activities of the entity through an IAS 39 hedging relationship, the gains and losses on such derivatives are not considered a borrowing cost as defined under IAS 23. The same treatment applies under IFRS 9.

3.6 *In computing the capitalisation rate for an entity, is the effect of cash flow or fair value hedging relationships on borrowings taken into account?*

Yes. IAS 39 designated hedging relationships modify the borrowing costs of the entity. Where an entity borrows funds not related to specific projects, the capitalisation rate computed in accordance with paragraph 14 of IAS 23 is calculated after taking into account effective hedging relationships designated under IAS 39 for all outstanding borrowings other than those borrowings made specifically for the purposes of obtaining a qualifying asset.

Ineffectiveness on such hedging relationships should continue to be recognised in profit or loss.

3.7 *Can management capitalise a 'notional' borrowing cost representing the opportunity cost of the cash employed in financing the asset's construction?*

No. A 'notional' borrowing cost cannot be capitalised. IAS 23 limits the amount that can be capitalised to the actual borrowing costs incurred. The standard does not address actual or imputed cost of equity. Where an entity has no borrowings and uses its own cash resources to finance the construction of property, plant and equipment, the entity cannot assume that interest that could have been earned on that cash represents forgone benefit and could be capitalised.

3.8 *An entity has investment income on general borrowings. Does management deduct investment income from the borrowing costs available for capitalisation?*

No. No specific guidance is given about general borrowings, unlike specific borrowings (borrowing costs less investment income). The funds invested 'temporarily' cannot be considered to be those from the general borrowings rather than from other sources (equity or cash generated from operating activities). It cannot therefore be demonstrated that the income is earned from the general borrowings.

3.9 *The entity uses general borrowings to finance its qualifying assets. However, cash flows from the operating activities would be sufficient to finance the capital expenditures incurred during the period. Can management claim that the general borrowings are used to finance working capital and other transactions (for example, merger and acquisition activity, finance leases) but not to finance the qualifying assets, in which case no borrowing costs would be capitalised?*

No. It is presumed that any general borrowings in the first instance are used to finance the qualifying assets (after any funds specific to a qualifying asset). This is the case even where the cash flows from operating activities are sufficient to finance the capital expenditures. The capitalisation rate is applied to the full carrying amount of the qualifying asset. Apportioning of general borrowings between acquisition and construction of qualifying assets and other expenditures (for example, on the basis of cash flows statement) is not supported by the guidance in IAS 23.

3.10 *How is the amount of borrowing costs eligible for capitalisation determined when a qualifying asset is financed by a combination of borrowings that are specific to the asset and by general borrowings?*

The amount of borrowing costs eligible for capitalisation is calculated as follows:

- The amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on a specific borrowing during the period, less any investment income on the temporary investment of those borrowings. [IAS 23 para 12].
- The amount of borrowing costs eligible for capitalisation on general borrowings is determined by applying a capitalisation rate to the expenditures on qualifying assets. The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. [IAS 23 para 14]. The following example illustrates how to calculate the amount of borrowing costs to be capitalised.

Illustrative example

On 1 July 2013, entity A entered into a C2.2 million contract for the construction of a building. The building was completed at the end of June 2007. During the period, the following payments were made to the contractor:

Payment date	Amount (C'000)
1 July 2013	200
30 September 2013	600
31 March 2014	1,200
30 June 2014	200
Total	2,200

Entity A's borrowings as at its year end of 30 June 2014 were as follows:

1. 10% four-year note with simple interest payable annually, which relates specifically to the project; debt outstanding at 30 June 2014 amounted to C700,000. Interest of C65,000 was incurred on these borrowings during the year, and interest income of C20,000 was earned on these funds while they were held in anticipation of payments.
2. 12.5% 10-year note with simple interest payable annually; debt outstanding at 1 July 2013 amounted to C1 million and remained unchanged during the year.
3. 10% 10-year note with simple interest payable annually; debt outstanding at 1 July 2013 amounted to C1.5 million and remained unchanged during the year.

Assume for the purposes of this example that interest expense equals borrowing costs.

Solution

Expenditures incurred in obtaining a qualifying asset are first allocated to any specific borrowings. The remaining expenditures are allocated to any general borrowings.

Analysis of expenditure:

	Amount (C'000)	Amount allocated to specific borrowing (C'000)	Amount allocated to general borrowings (C'000)	Weighted for period outstanding (C'000)
1 July 2013	200	200	-	-
30 September 2013	600	500	100*	100 x 9/12 = 75
31 March 2014	1,200	-	1,200	1,200 x 3/12 = 300
30 June 2014	200	-	200	200 x 0/12 = 0
Total	2,200	700	1,500	375

*Specific borrowings of C700,000 are fully utilised; remainder of expenditure is therefore allocated to general borrowings.

The capitalisation rate relating to 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.

Weighted average borrowing cost: $12.5\% (1,000/2,500) + 10\% (1,500/2,500) = 11\%$

Borrowing costs to be capitalised	Amount (C)
Specific loan	65,000
General borrowings (C375,000 x 11%)	41,250
Total	106,250
Less interest income on specific borrowings	(20,000)
Amount eligible for capitalisation	86,250

Therefore, the borrowing costs to be capitalised are C86,250.

3.11 *Are specific borrowings transferred to the general borrowings pool once the respective qualifying asset is completed?*

Yes. If specific borrowings were not repaid once the relevant qualifying asset was completed, they become general borrowings for as long as they are outstanding.

The borrowing costs that are directly attributable to obtaining qualifying assets are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. If cash was not spent on other qualifying assets, it could be directed to repay this specific loan. Thus, borrowing costs could be avoided (that is, they are directly attributable to other qualifying assets).

3.12 *When the construction of a qualifying asset is performed by a third party, are borrowing costs capitalised on the prepayments made to the third party for the acquisition of the asset?*

Yes. The borrowing costs incurred by an entity to finance prepayments on a qualifying asset are capitalised on the same basis as the borrowing costs incurred on assets constructed by the entity.

The capitalisation starts when all three conditions are met: expenditures are incurred; borrowing costs are incurred; and the activities necessary to prepare the asset for its intended use or sale are in progress.

Expenditures on the asset are incurred when the prepayments are made (payments of the instalments). Borrowing costs are incurred when borrowing is obtained. The last condition – the activities necessary to prepare the asset for its intended use or sale are in progress – can vary, depending on facts and circumstances.

3.13 *An entity has arranged a loan to acquire a subsidiary. Should borrowing costs incurred on this loan be excluded from general borrowing costs eligible for capitalisation?*

No. The IASB considered in 2009 whether debt incurred specifically to acquire a non-qualifying asset could be excluded from general borrowings. The Board noted that IAS 23 excludes only debt used to acquire qualifying assets from the determination of the capitalisation rate. Thus, all borrowings which are not specific borrowings should be taken into account when determining costs eligible for capitalisation.

3.14 *Borrowing costs were capitalised in the accounting records but expensed for tax purposes. Should borrowing costs capitalised be net of the related tax effect?*

Borrowing costs should be capitalised gross of tax. Tax effects will be considered in deferred tax calculation.

4. Borrowing costs in group financial statements

A number of practical issues arise with respect to capitalisation of borrowing costs in the consolidated financial statements of a group. Are the borrowing costs that are eligible for capitalisation in consolidated financial statements simply a sum of borrowing costs capitalised by subsidiaries in their own financial statements? What is the amount of general borrowings capitalised in consolidated financial statements, if qualifying assets are in one group entity and general borrowings in another?

Financial statements of group entities have their own issues when construction of a qualifying asset is financed by intra-group loans. This section focuses on issues arising both in consolidated financial statements of a group and in those of individual entities in a group.

4.1 *A subsidiary finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the financial statements of the subsidiary?*

Yes. Borrowing costs are capitalised by the subsidiary in its separate financial statements to the extent of the actual costs incurred by the subsidiary.

4.2 *A subsidiary finances a qualifying asset through a capital increase, which is provided by the parent company. Can a notional amount of borrowing costs be capitalised in the separate financial statements of the subsidiary?*

No, because the subsidiary has not incurred any borrowing costs. The standard does not permit capitalisation of actual or imputed cost of equity.

4.3 *Assume the same fact pattern as in 4.1 and 4.2 above. However, the parent company finances the inter-company loan or capital increase with a bank loan. How is this treated in the financial statements of the parent company?*

In its separate financial statements, the parent recognises only the investment in the subsidiary. This is not a qualifying asset, so the borrowing costs cannot be capitalised.

In the consolidated financial statements of the parent, capitalisation of borrowing costs is required. However, the amount of the borrowing costs incurred by the subsidiary in the case of inter-company loans might be adjusted to reflect how the qualifying asset was financed from the perspective of the group as a whole:

- If the group uses external general borrowings, the borrowing costs capitalised by the subsidiary are adjusted if the capitalisation rate at the group level is different from the rate used by the subsidiary.
- If the group uses specific external borrowings, the borrowing costs are adjusted if the borrowing costs on the external borrowings vary from the amount of borrowing costs capitalised by a subsidiary.

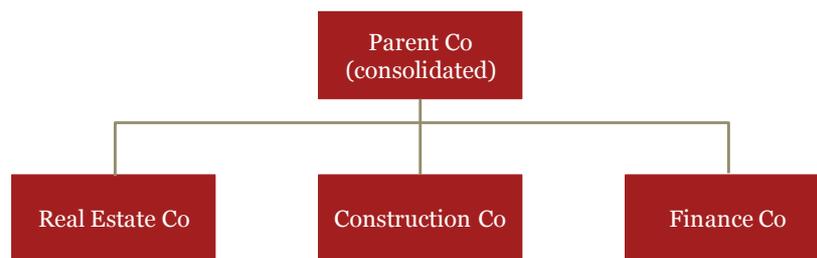
Borrowing costs calculated and capitalised in accordance with IAS 23 cannot exceed the amount of borrowing costs incurred by the group.

4.4 How are borrowing costs determined if qualifying assets are in one group entity and general borrowings in another?

Consolidated financial statements are prepared as if they were the financial statements of a single entity. Therefore, the following guidelines are useful:

1. The intra-group interest is eliminated in consolidated financial statements.
2. All borrowings of a parent and subsidiaries would normally be included in one pool, unless there are significant restrictions on transfer of funds among entities in the group (for example, currency regulations or other restrictions imposed by government).

Illustrative example – Group situations



- Parent Co has no operating activities of its own but performs management functions for its subsidiaries.
- Financing activities and cash management in the group are coordinated centrally.
- Finance Co is a vehicle used by the group solely for raising finance.
- All entities in the group prepare IFRS financial statements.

The following information is relevant for the current reporting period:

Real Estate Co:

- External general borrowings of C1,000,000 with an interest rate of 7% pa.
- Expenditures on qualifying assets during the period amounted to C1,540,000.
- All construction works were performed by Construction Co. Amounts invoiced to Real Estate Co included 10% profit margin.

Construction Co:

- No borrowings during the period.
- Financed C1,000,000 of expenditures on qualifying assets using its own cash resources.

Finance Co:

- Raised C2,000,000 at 7% pa externally and issued a loan to Parent Co for general corporate purposes at the rate of 8%.

Parent Co:

- Used loan from Finance Co to acquire a new subsidiary.
- No qualifying assets apart from those in Real Estate Co and Construction Co.
- Parent Co did not issue any loans to other entities during the period.

Question: What is the amount of borrowing costs eligible for capitalisation in the financial statements of each of the four entities for the current reporting period?

Solution

Finance Co:

No expenditure on qualifying assets have been incurred, so Finance Co cannot capitalise anything.

Real Estate Co:

Total interest costs in the financial statements of Real Estate Co equal C70,000. Expenditures on qualifying assets exceed total borrowings, so the total amount of interest can be capitalised.

Construction Co:

No interest expense has been incurred, so Construction Co cannot capitalise anything.

Consolidated financial statements of Parent Co:

Total general borrowings of the group:

C1,000,000 (Real Estate Co) + C2,000,000 (Finance Co) = C3,000,000

Although Parent Co used proceeds from its loan to acquire a subsidiary, this loan cannot be excluded from the pool of general borrowings.

Total interest expenditures for the group = C3,000,000 x 7% = C210,000

Total expenditures on qualifying assets for the group are added up. Profit margin charged by Construction Co to Real Estate Co is eliminated:

Real Estate Co – C1,540,000/1.1 = C1,400,000

Construction Co – C1,000,000

Total consolidated expenditures on qualifying assets: C(1,400,000 + 1,000,000) = C2,400,000

Capitalisation rate = 7%

Borrowing costs eligible for capitalisation = C2,400,000 x 7% = C168,000

Total interest expenditures of the group are higher than borrowing costs eligible for capitalisation calculated based on the actual expenditures incurred on the qualifying assets.

Therefore, only C168,000 can be capitalised.

5. Foreign exchange differences

IAS 23 requires capitalisation of foreign exchange differences relating to borrowings to the extent that they are regarded as an adjustment to interest costs. The gains and losses that are an adjustment to interest costs include the interest rate differential between borrowing costs that would be incurred if the entity borrowed funds in its functional currency and borrowing costs actually incurred on foreign currency borrowings. Foreign exchange gains and losses might include effects of other economic factors as well. The question is how to determine what portion of foreign exchange differences arises due to the differential between the interest rates in two countries and, thus, represents an adjustment to interest costs. We consider below some scenarios that frequently arise in practice.

Foreign exchange loss on borrowings in a currency that is stronger than the functional currency

The interest rate on borrowings in a currency that is stronger than an entity's functional currency is usually lower than the rate on equivalent borrowing in the functional currency. When the functional currency depreciates against the currency of borrowings during a period, the entity incurs foreign exchange loss on its borrowings.

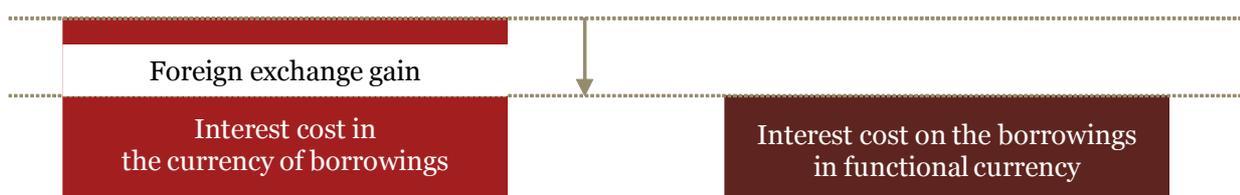


Total expense on borrowings (interest cost plus foreign exchange loss) approximates to the interest cost of the equivalent borrowing in the functional currency. In this situation, the foreign exchange loss compensates for the lower interest rate and is likely to represent an adjustment to interest cost (or at least some portion of it). The foreign exchange loss is therefore an addition to interest costs. The actual amount of loss that can be capitalised should be determined. Please see the discussion at the end of this section.

Foreign exchange gain on borrowings in a currency that is weaker than the functional currency

An entity might have a functional currency that is different from the currency of a country where it operates. This might occur when a subsidiary is not considered autonomous from its overseas parent and, thus, has the same functional currency as the parent. It also occurs in some specific industries, such as the petroleum industry, where the US dollar is often the functional currency of upstream companies. So an entity might have a functional currency which is stronger than its local currency.

The interest rate on borrowings in the local currency might be higher than on equivalent borrowings in the entity's functional currency. The entity will record a foreign exchange gain if the currency of borrowings depreciates against the entity's functional currency.



The higher interest cost of the borrowing in the local currency is partially offset by foreign exchange gains. Net expense on borrowings in the local currency approximates to the interest cost of the equivalent borrowing in the entity's functional currency. In this situation, foreign exchange gain compensates for higher interest rate and is likely to represent an adjustment to interest costs (or at least some portion of it). Thus, foreign exchange gain is deducted from interest costs. The actual amount of loss that can be capitalised should be determined. Please see the discussion at the end of this section.

The two scenarios above illustrate that total cost of borrowing in different currencies is not expected to differ significantly. The foreign exchange difference in many cases normalises the cost of borrowing in different currencies and is considered an adjustment to interest costs in such cases. The differential between the interest rates in two countries, however, is not the only factor that influences exchange rates between their currencies. Other economic factors, such as unemployment rate, productivity or government currency regulation, might have significant impact on exchange rates. It is difficult to determine the role of various factors on exchange rates. In simplest terms, foreign exchange differences cannot be considered an adjustment to interest costs if they move borrowing costs in different currencies further apart instead of bringing them closer together.

IAS 23 does not prescribe which method should be used to estimate the amount of foreign exchange differences that can be included in borrowing costs.

The following two methods were considered by the IFRIC staff:

1. The portion of the foreign exchange movement can be estimated based on interest rates on similar borrowings in the entity's functional currency.
2. The portion of the foreign exchange movement can be estimated based on forward currency rates at the inception of the loan.

In using either method, an entity cannot capitalise more costs than the actual total costs incurred. Other methods might be possible. Management uses judgement to assess which foreign exchange differences can be capitalised. The method used is an accounting policy choice. The method should be applied consistently to foreign exchange differences, whether they are gains or losses.

6. Cessation of capitalisation

A qualifying asset might be completed in parts, and each part can be used or operated separately. Capitalisation for one given phase or part ceases when this part is ready for its intended use or sale. Each subsequent phase will give rise to capitalisation of borrowing costs over its own construction period.

Illustrative example – Assets completed in phases

Telecom entity A is in the process of rolling out its 3G network. Entity A plans to commence the offering of 3G services once it has achieved 60% population coverage. Throughout the rollout period, which lasts for 18 months, entity A completes the rollout of cell sites, testing the sites and the leased lines and microwave links between the sites and the core network. Testing the network sites continues up to the point that entity A achieves 60% population coverage. Certain final tests on all sites are completed just in advance of the commercial launch and are vital to confirming the network's operational readiness.

Over which period does entity A capitalise borrowing costs?

Entity A capitalises borrowing costs incurred from the inception of the rollout through to the confirmation of the network's overall operational readiness. While parts of the network are built over time and much of the network testing is also completed over the 18-month rollout period, the final testing and sign-off of the network's operational readiness is not completed until just before entity A is ready to launch the network.

The network assets are not 'ready for use in the manner intended by management' until the final network tests covering 60% of the population. Capitalisation on the remaining 40% will commence when construction activities for that 40% start.

7. Interaction between IAS 23 and IAS 11

An entity might be constructing an asset for a customer under a construction contract to which IAS 11, 'Construction Contracts', applies. Borrowing costs that are directly attributable to the construction of an asset which is accounted for under IAS 11 are treated as contract costs in accordance with IAS 23 and IAS 11 and included in the total cost of the asset.

The determination of the amount of borrowing costs to be capitalised in the financial statements of the constructor is based on the net position of the contract, after deducting customer payments received in advance in respect of the contract. No borrowing costs are capitalised when advances from customers exceed the contract costs incurred and the contract is in a net credit position during the whole construction period. The constructor has not incurred any borrowing costs, as the financing was provided by the client.

The net position in a contract might change over the construction period from net debit to net credit (or vice versa). Capitalisation is required for those periods when the contract is in a net debit position.

8. First-time adoption

An entity transitioning to IFRS might have expensed all borrowing costs or used a methodology that was different from IAS 23 under previous GAAP. IFRS 1 provides an exemption for retrospective application of IAS 23 and permits two options. The entity can start capitalisation of borrowing costs under IAS 23 either from the date of transition or from an earlier date that management designates as a commencement date under paragraph 28 of IAS 23.

The entity should not restate the amount of borrowing costs that was capitalised under previous GAAP as at the date when the entity chooses to apply IAS 23. Borrowing costs incurred after this date on qualifying assets already under construction should be accounted for under IAS 23.

For further information visit inform.pwc.com or contact your usual PwC contact.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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