# Accounting Standard Study Group

## CIMA Sri Lanka division

### SLAS 20: Borrowing costs

#### Objective

This standard interprets how borrowing costs should be treated in the organisation's financial statements.

Though the standard generally requires borrowing costs to be charged as an expense to the P&L, standard also allows capitalising borrowing costs as an allowed alternative. It moves on to state that capitalising is only allowed when the associated costs are directly attributable to the acquisition, construction or production of a qualifying asset.

#### Scope

- Accounting for borrowing costs.
- This Standard does not deal with the actual or imputed cost of equity, together with preferred capital not classified as a liability.

#### Key definitions

Some of the key definitions pertaining to SLAS 20 are indicated below;

Borrowing costs: Interest and any other costs incurred in connection with borrowing of funds.
Borrowing costs would include the following:

- Interest on bank over drafts and other short or long-term borrowings.
- Amortisation of discounts or premiums relating to borrowings.
- Amortisation of additional costs incurred in connection with the arrangement of borrowings. For example, legal fees.
- Finance charges in respect of finance leases.
- Exchange rate differences that arise from borrowings denoted in foreign currency, when such adjustments are significant enough to be considered as an adjustment to interest costs.

Qualifying asset: These are assets that require substantial preparation time in bringing it to its intended use or sale. Inventories that require considerable time in bringing them to saleable condition, manufacturing plants, power generation facilities and investment properties may fall under qualifying assets.

Inventories produced in large quantities repeatedly over a short period of time and assets that are ready for their intended use or sale at the time of purchase - like the stocks to be sold in a business are excluded.

## Key principles

Borrowing costs can be recognised and treated under two separate methods.

- Benchmark treatment: The borrowing costs are treated as an expense in the P&L during the period in which they are incurred.
  Disclosures: The financial statements should disclose the accounting policy adopted in accounting for borrowing costs.

- Allowed alternative treatment: This method allows costs that are directly attributable to the acquisition, construction or production of a qualifying asset to be included to the cost of the asset. If funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs shall be determined as actual borrowing cost incurred during the period less any investment income on investment of these borrowings. The cost to capitalise is limited by the actual borrowing cost incurred during the period. An entity may begin capitalisation on the commencement date, that is, when all three of the following conditions are met.
  - Expenditure is incurred for the asset.
  - Borrowing costs are incurred.
  - Activities needed to prepare the assets for its intended use or sale has already begun.

- Suspension of capitalisation

The standard doesn't allow borrowing costs to be capitalised during extended periods when the active development of the asset is interrupted. For example, the cost of holding an incomplete asset does not qualify to be capitalised. However, if substantial technical or administrative costs work is carried out on the asset, capitalisation of borrowing costs is allowed.

- Cessation of capitalisation

Borrowing costs can only be capitalised to the point till the qualifying asset has reached its intended purpose, this would mean that capitalising borrowing costs would stop once the construction of the asset is completed.

## Disclosures in financial statements

The standard requires organisations to disclose the following.

- The accounting policy adopted for borrowing costs
- The amount of borrowing costs capitalised during the year.
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

## Key points to note form a business perspective

When borrowed funds are directly attributable to purchasing a qualifying asset, the borrowing costs are readily identifiable. However, organisations are likely to face difficulties in identifying the borrowing costs when organisation's financing activities are co-ordinated centrally through the head office (treasury), and when the funds used for the purchase of asset is raised through a range of debt instruments with varying rates of interest.

Complications also arise as organisations utilise loans denominated in or linked with foreign currencies where the borrowing costs would vary as a result of high inflation and exchange rate fluctuations.

With well structured treasury functions, larger organisations asses and invest the borrowed funds in the short-term (daily) until funds are actually disbursed to purchase the asset. In such circumstances, the income earned on investment of funds would be deducted from the borrowing costs prior to capitalising.

When a qualifying asset is purchased from a pool of borrowed funds with varying rates of interest, the borrowing costs to be capitalised would be determined by calculating the weighted average of borrowing costs that are outstanding during the period.

## Dealing with specific business situations

### When carrying amount exceeds the recoverable amount of the asset

Certain assets with low recoverable/net realisable values tend to be overstated subsequent to inclusion of the borrowing costs to the value of the asset.

The standard recommends a write-down or a writing-off of the value so that its net realisable value is reflected in the financial statements and when considering the asset values for management information.

### When to capitalise the qualifying asset?

The capitalisation of a qualifying asset should take place when the following three conditions are met.

- Expenses on the asset is incurred (the expenses include those that have resulted in payment of cash, transfer of assets or interest bearing liabilities)
- Borrowing costs are being incurred.
- When progress is made on necessary activities in bringing the asset to its intended use or sale. The activities here include technical and administrative work prior to the commencement of physical construction.

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