Educational Material on Ind AS 23, Borrowings Costs

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

Educational Material on Indian Accounting Standard (Ind AS) 23, *Borrowing Costs*

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(Set up by an Act of Parliament)
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This Educational Material has been formulated in accordance with the Ind AS notified by the Ministry of Corporate Affairs (MCA) as Companies (Indian Accounting Standards) Rules, 2015 vide Notification dated February 16, 2015 and other amendments finalised and notified till July 2020.

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Foreword

The Financial Reporting environment in India has undergone significant reform with the advent of the IFRS converged Indian Accounting Standards. This set of new accounting standards has made the financial reporting in India on par with the financial reporting across the globe. ICAI is playing a paramount role in this new era of accounting reforms in India. This has resulted in the enhancement of comparability of the Financial Statements of Indian Companies with the Companies all over the World. Comparability between entities and consistency in the application of principles over time increases the informational value of comparisons of relative economic opportunities or performance. We at the ICAI are committed and playing leading role for smooth implementation of Ind AS and have been taking various initiatives for training of accounting professionals, creating awareness and providing guidance. Stakeholders are benefitted by our various related initiatives to enhance their skill-sets and capabilities and making this ongoing major accounting reform in India a big success.

In light of the objectives for providing guidance on implementation of Ind AS, the Accounting Standards Board of the Institute of Chartered Accountants of India has formulated an Educational Material on Ind AS 23, *Borrowing Costs* which provides adequate guidance on the implementation of the Standard for recognising the borrowing costs incurred by entities. This publication contains a summary of the Standard and Frequently Asked Questions (FAQs) that are likely to be encountered while applying the Standard.

I would like to offer my sincere gratitude and appreciation for the efforts put in by CA. M P Vijay Kumar, Chairman, CA. Sanjeev Singhal, Vice-Chairman, and other members of the Accounting Standards Board for their immense efforts to formulate this publication for the benefit of the stakeholders and the members of the Institute, keeping in mind the practical aspects of the Indian accounting system.

I am sure that the publication would be of immense use to professionals and other stakeholders while implementing and applying the Ind AS for fulfilling their financial reporting requirements.

New Delhi
January 10, 2021

CA. Atul Kumar Gupta
President, ICAI

Preface

In the era of highly competitive global economy, it is imperative for the businesses to have financial reports comparable across the world. To achieve this comparability, the Institute of Chartered Accountants of India (ICAI) have formulated the IFRS-converged Indian Accounting Standards (Ind AS) pursuant to the provisions of Section 133 of the Companies Act, 2013. Implementation of Ind AS has been driven by tireless efforts of the ICAI to make sure that the principles are consistently applied in the preparation of the financial statements. For this purpose, ICAI is actively engaged in providing guidance to members and other stakeholders through its various collective efforts in programs and publications.

The Accounting Standards Board has been making relentless efforts to ensure effective implementation of Ind AS through its various endeavours. The Board has been working tirelessly to provide guidance to the members and other stakeholders on the notified Ind AS. For this purpose, Educational Materials on various Ind AS covering various issues have been issued. Apart from this, the Board has also launched Online Certificate Course on Ind AS and it conducts In-house training programmes on Ind AS for regulatory bodies such as RBI, C&AG, IRDAI, CBDT etc. and other corporate entities, develops video lectures on Ind AS, organises seminars, awareness programmes on Ind AS and series of webcasts on Ind AS.

The Ind ASs provide accounting and financial reporting guidance in respect of various aspects of the financial transactions of the entities. One such aspect is the borrowings of entities and the costs incurred by entities on such borrowings for financing its various activities. Ind AS 23, *Borrowing Costs* lays down the principles relating to accounting of same. To provide guidance on application and implementation of Ind AS 23, *Borrowing Costs*, the Accounting Standards Board has formulated this Educational Material which provides guidance on various practical issues in the form on Frequently Asked Questions (FAQs) that the preparers of the financial statements face while applying the Standard.

I would like to convey my sincere gratitude to our Honourable President, CA. Atul Kumar Gupta and Vice-President, CA. Nihar Jambusaria for providing us the opportunity of bringing out this publication. We are also thankful to the Vice Chairman CA (Dr) Sanjeev Singhal as well as convenor of the study

group for his active guidance in formulation of this publication. I would also like to thank all the members of the Accounting Standards Board for their valuable contribution in various endeavours of the Board.

I acknowledge with thanks the technical contribution made by the members of the study group, CA. Nikhil Agrawal, CA. Neeraj Bansal, CA. Kulbhushan Sharma, CA. Hari Nagrani, CA. Charan Gupta, CA. Anuradha Jain, CA. Shabadjeet Singh Soin in drafting the Educational material and CA. Parminder Kaur, Secretary, CA. Ruchika Gupta, Assistant Project Officer, CA. Prachi Jain, Executive Officer and CA. Choshal Patil, Consultant, Accounting Standards Board in bringing out this publication.

I believe that this publication would be of great help to the members and other stakeholders for overall understanding and implementation of Ind AS 23.

CA. M P Vijay Kumar
Chairman
Accounting Standards Board

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Educational Material on Indian Accounting Standard (Ind AS) 23, *Borrowing Costs*

I. Summary

Definition

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

This standard is not required to be applied to borrowing costs directly attributable to the acquisition, construction or production of:

(a) a qualifying asset measured at fair value, for example, a biological asset within the scope of Ind AS 41, *Agriculture*; or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

The actual or imputed cost of equity, including preferred capital not classified as a liability is also not dealt with in this standard.

Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. It may include:

- interest expense calculated using the effective interest method as described in Ind AS 109, *Financial Instruments*;
- interest in respect of lease liabilities recognised in accordance with Ind AS 116, *Leases*; and
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

With regard to exchange difference required to be treated as borrowing costs, the standard lays down the following manner of arriving at the stated adjustments mentioned above:

(i) the adjustment should be of an amount which is equivalent to the extent to which the exchange loss does not exceed the difference between the cost of borrowing in functional currency when compared to the cost of borrowing in foreign currency.

(ii) where there is an unrealised exchange loss which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognised as an adjustment should also be recognised as an adjustment to interest.

Qualifying Assets

A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

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

Recognition

An entity should 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 should recognise other borrowing costs as an expense in the period in which it incurs them.

Directly attributable costs are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

<u>Specific Borrowings</u>

When an entity borrows funds specifically for the purpose of obtaining a qualifying asset, it determines the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

General Borrowings

When an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, it determines the eligible borrowing costs by applying a capitalisation rate to the expenditure on that asset.

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

In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average rate of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average rate of the borrowing costs applicable to its own borrowings.

The amount of borrowing costs that an entity capitalises during a period should not exceed the amount of borrowing costs it incurred during that period.

Commencement of capitalisation

An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date, which is the date when it first meets all of the following conditions:

(a) it incurs expenditures 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.

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They 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.

Suspension of capitalisation

Capitalisation should be suspended during extended periods in which it suspends active development of a qualifying asset.

Borrowing costs may incur during an extended period in which the activities

necessary to prepare an asset for its intended use or sale are suspended. Such costs are costs of holding partially completed assets and do not qualify for capitalisation.

Normally, when substantial technical and administrative work is being carried out capitalisation is not suspended.

Borrowing costs are not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period when high water levels delay construction of a bridge, as such high-water levels are common during the construction period in the geographical region involved.

Cessation of capitalisation

Capitalisation should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

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 should cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale. For example: A business park comprising several buildings, each of which can be used individually.

Disclosure

The following disclosures are required:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

II. Frequently Asked Questions (FAQs)

Question 1

Grapewine Ltd. is in the business of producing wine in large quantities on repetitive basis in its wine making facilities. It finances the production of wine through external loans. Should interest costs incurred by it to finance the production of wine be capitalised as per Ind AS 23?

Response

Certain items of inventories may require a substantial period of time for its production due to the processes the products undergo. For example, production of wine requires ageing process which may require a substantial period of time, say more than 12 months for wine to be ready for sale. During this period an entity bears the financing costs for production of such inventory.

Paragraph 2 of Ind AS 23 specifically states that:

"**2 An entity shall apply this Standard in accounting for borrowing costs**."

Further, the core principle of Ind AS 23 given in paragraph 1 state:

"**1 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.**"

However, paragraph 4 of Ind AS 23 states that, "An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

(a) a qualifying asset measured at fair value, for example, a biological asset within the scope of Ind AS 41, *Agriculture*; or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis."

A combined reading of the above paragraphs indicates that Ind AS 23 prescribes accounting for all borrowing costs depending upon the nature of the borrowing costs. According to the standard, where borrowing costs are directly attributable to the acquisition, construction or production of a qualifying asset, these shall form part of the cost of that asset otherwise these will be recognised as expense. However, in case the borrowing costs

are directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis, paragraph 4 of Ind AS 23 provides that an entity is not required to capitalise borrowing costs on such inventories. The entity is not required, considering costs and efforts involved in allocating the borrowing costs to such inventories and monitoring such costs until the inventories are sold may exceed the potential benefits derived from doing such exercise. Where an entity elects to apply the requirements of Ind AS 23 to such assets, then it shall capitalise the borrowing costs that are directly attributable to the acquisition, construction or production of such assets subject to fulfillment of other requirements of the standard. The entity should consistently follow the approach and disclose in the notes to financial statements.

In the given case, since Grapewine Ltd. is producing wine (which takes substantial period of time to get ready for sale) in large quantities on a repetitive basis, therefore as per paragraph 4(b) of Ind AS 23, it may elect to either apply Ind AS 23 and capitalise the interest costs directly attributable to production of wine or it may choose to expense these costs in profit or loss. It should disclose the same in the notes to accounts and must follow the same consistently.

Question 2

PQR Ltd. is in the process of constructing a large manufacturing plant in a backward area. Due to the unavailability of housing resources in the backward area, it has also purchased a residential building, which is to be used for housing the workers engaged in the construction of the plant. The purchase cost of the building is met by raising a long-term loan from a bank. The company intends to dispose off the building once the construction of the manufacturing plant is complete. Assuming that the manufacturing plant meets the definition of a qualifying asset, would the borrowing costs incurred on funds borrowed to purchase the residential building be eligible for capitalisation as per Ind AS 23?

Response

In the given scenario, PQR Ltd. is constructing a manufacturing plant in a backward area where the resources to station the construction workers are not available. Therefore, PQR Ltd. has borrowed funds and purchased a residential building in the backward area to house the workers for the construction of its manufacturing plant.

Paragraph 5 of the Standard defines a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

In the above scenario, manufacturing plant is a qualifying asset and residential building itself is not a qualifying asset.

Paragraph 8 of Ind AS 23 gives guidance on the recognition of borrowing costs which *inter-alia* states that:

"**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.**"

Further, paragraph 10 of Ind AS 23 explains what borrowing costs are eligible for capitalisation which *inter-alia* states that:

"10 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. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified."

It is a matter for careful consideration as to whether a certain expenditure is directly related and incidental to construction of a qualifying asset, or whether it would be more appropriate to treat it as an item of other indirect expenditure not related to qualifying asset and therefore not eligible for ultimate inclusion in the cost of that asset.

In the given case, the expenditure incurred to construct the residential building is related to construction of a qualifying asset and is incidental thereto. Furthermore, PQR Ltd. intends to dispose off the residential building on completion of the construction of manufacturing plant and the only reason it has purchased the said residential building is for the construction of the manufacturing plant. Therefore, it can be said that the finance costs incurred by PQR Ltd. on the funds borrowed to purchase the residential building are borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset i.e. manufacturing plant and thus are eligible for capitalisation. Hence, such borrowing costs should be capitalised as a

part of the cost of manufacturing plant according to the requirements of Ind AS 23, *Borrowing Costs*.

Question 3

M Ltd. entered into a contract with a ship builder company S Ltd and ordered it to construct 3 ships for its fleet on April 1, 2018. The terms of the contract are commercially negotiated as per which M Ltd. makes a down payment of 25% of the contract value of each of the ship. The balance amount is to be paid at the time of delivery. The contract also specifies that the construction activity for all the three ships should be completed by not later than financial year 2023. On March 1, 2019, the ship builder informs that planning and designing activity (being substantive activities) for the said ships is in progress but, construction activity has not commenced for any of the three ships. M Ltd. pays the down payment out of long-term borrowings taken from a scheduled bank and is incurring borrowing costs on the same. Is it permissible for M Ltd. to capitalise borrowing costs for the financial year ended March 31, 2019 or March 31, 2020?

Response

As per paragraph 5 of Ind AS 23:

"**5 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.**"

As per paragraph 17 of Ind AS 23:

"**17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:**

(a) it incurs expenditures 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.**"

The ship is a qualifying asset as it takes substantial period of time for its construction. Thus, the related borrowing costs should be capitalised.

M Ltd. borrows funds and incurs expenditure in the form of down payment on April 1, 2018. Thus, condition (a) and (b) are met. Regarding the meeting of

condition (c), it may be noted that the standard provides that the entity must undertake activities to prepare the asset to be able to commence capitalisation. In this regard, it is pertinent to note that in the given case, although the construction activity is not being undertaken by M Ltd. itself as it has given contract to a third party to do the same. However, this cannot preclude M Ltd. from capitalising the borrowing costs that it is incurring for the said asset because it has made down payment to third party so that the third party can commence construction of the asset. Further, the said party is also undertaking activities that are necessary to prepare the asset on behalf of M Ltd. Therefore, it would be acceptable to capitalise the borrowing cost even if these activities are being carried out by a third party.

Hence, in the given case condition (c) for M Ltd. is also met on April 1, 2018 itself, as S Ltd, is undertaking planning and designing activities. Accordingly, M Ltd. can commence capitalising borrowing costs relating to all the three ships from the period ending March 2019 itself.

Question 4

X Ltd. has a treasury department that arranges funds for all the requirements of the Company including funds for working capital and expansion programs.

During the year ended March 31, 2020, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	**Amount (Rs)**
July 1, 2019	2,50,000
December 1, 2019	3,00,000

The details of borrowings and interest thereon are as under:

Particulars	**Average Balance (Rs.)**	**Interest (Rs.)**
Long term loan @ 10%	10,00,000	1,00,000
Working Capital Loan	5,00,000	65,000
Total	15,00,000	1,65,000

Compute the borrowing costs that should be capitalised as per Ind AS 23.

Response

The Standard provides guidance for capitalisation of borrowing costs of the

funds generally borrowed in paragraph 14 which states as follows:

"14 [1]To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity shall exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period."

Therefore, based on the above guidance the interest to be capitalised is computed as follows:

Computation of Capitalisation rate:

$$\frac{(\text{Amount of borrowing}_1 \text{ x Interest rate}_1) + (\text{Amount of borrowing}_2 \text{ x Interest rate}_2)}{\text{Total amount of borrowings outstanding during the year}} \times 100$$

$$= \frac{(1,00,000) + (65,000)}{15,00,000} \times 100 \qquad = 11\%$$

Interest will be capitalised as under:

- On Rs. 2,50,000 @ 11% p.a. for 9 months = Rs. 20,625
- On Rs. 3,00,000 @ 11% p.a. for 4 months = Rs. 11,000

Question 5

X Ltd. commenced the construction of a plant (qualifying asset) on September 1, 2019, estimated to cost Rs. 10 crores. For this purpose, X has not raised any specific borrowings, rather it intends to use general borrowings, which have a weighted average cost of 11%. Total borrowing costs incurred during the period, viz., September 1, 2019 to March 31, 2020

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[1] Substituted vide Notification No. G.S.R. 274(E) dated 30th March, 2019

were Rs. 0.5 crore.

The other relevant details are as follows:

(Rs. in crore)

Month	Cost of construction accrued	Cash outflows (paid in advance at the start of each month)
September	1.50	3.00
October	0.50	1.70
November	1.50	2.50
December	0.50	—
January	1.80	1.00
February	0.70	—
March	3.00	1.50

What is the amount of interest that should be capitalised to the cost of the plant in the financial statements for the year ended March 31, 2020?

Response

Paragraph 14 of Ind AS 23, *inter-alia*, states:

"14 [2]To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity shall exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period."

In this context, a question arises whether such expenditure should be based on costs accrued or actual cash outflows. To contrast these two alternatives,

[2] Substituted vide Notification No. G.S.R. 274(E) dated 30th March, 2019

presented below is the computation of borrowing costs based on both the alternatives:

Month	Costs accrued	Average capital expenditure	Cash outflows	Average capital expenditure
September	1.50	1.50x7/12 = 0.875	3.00	3.00x7/12=1.75
October	0.50	0.50x6/12 = 0.25	1.70	1.70x6/ 12 = 0.85
November	1.50	1 .50x5/12 = 0.625	2.50	2.50x5/12 = 1.04
December	0.50	0.50x4/12 = 0.17	-	-
January	1.80	1.80x3/12 = 0.45	1.00	1x3/12 = 0.25
February	0.70	0.70x2/12 = 0.12	-	-
March	3.00	3.00x1/12 = 0.25	1.50	1.50x1/12 = 0.125
	9.50	**2.74**	**9.70**	**4.02**

If the average capital expenditure on the basis of costs accrued is taken, the borrowing costs eligible to be capitalised would be Rs. 2.74 crore x 11% = 0.30 crore. Whereas if average capital expenditure on the basis of cash flows is taken, the borrowing costs eligible to be capitalised would be Rs. 4.02 crore x 11% = 0.44 crore. Thus, there is a wide variance in the amount of borrowing cost to be capitalised, based on the accrual basis and on actual cash flows basis. This divergence is often experienced during the implementation of large projects, for example, an advance given to a supplier involves an upfront cash outflow while the actual expenditure accrues in later periods (with the receipt of goods and services).

In this regard, paragraph 18 of Ind AS 23 states that:

"18 Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditures are reduced by any progress payments received and grants received in connection with the asset (see Ind AS 20, *Accounting for Government Grants and Disclosure of Government Assistance*). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period."

Where cash has been paid but the corresponding cost has not yet accrued

interest becomes payable on payment of cash. Therefore, the amount so paid should be considered for determining the amount of interest eligible for capitalisation, subject to the fulfillment of other conditions prescribed in paragraph 16 of Ind AS 23. Accordingly, in the present case, interest should be computed on the basis of the cash flows rather than on the basis of costs accrued. Therefore, the amount of interest eligible for capitalisation would be Rs. 0.44 crore.

Another important factor to be noted is that paragraph 14 requires, *inter alia*, that "The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period." Thus, the amount of borrowing costs to be capitalised should not exceed the total borrowing costs incurred during the period, that is Rs. 0.5 crore.

Question 6

On 1 January 2019, A Ltd. entered into a contract for the construction of a building for Rs. 35,00,000. The building was completed at the end of March 2020. During the period, the following payments were made to the contractor:

Payment date	**Amount (Rs.)**
01-Apr-19	5,00,000
30-Jun-19	10,00,000
31-Dec-19	15,00,000
31-Mar-20	5,00,000
Total	**35,00,000**

Details of borrowings are as below:

(i)	Loan from Bank D specifically for the project on April 1, 2019	Rs. 7,00,000
	Simple interest payable annually	10%
	Interest for the year	Rs. 70,000
	Income earned while loans were held in anticipation of payment	Rs. 20,000
(ii)	12% Debentures with simple interest payable annually	Rs. 20,00,000

Amount did not change during the year

(iii)	10% Bond with simple interest payable annually Amount did not change during the year	Rs.	20,00,000

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

Response

Paragraphs 12 and 14 of Ind AS 23 state as follows:

"12 To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings."

"14 [3]To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity shall exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period."

In accordance with the above, the amount of borrowing costs eligible for capitalisation is as follows:

- The actual borrowing costs incurred on a specific borrowing during the period less any investment income on the temporary investment of those borrowings.
- For general borrowings it is determined by applying a capitalisation

[3] Substituted vide Notification No. G.S.R. 274(E) dated 30th March, 2019

rate to the expenditure 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.

Expenditure incurred in obtaining a qualifying asset are first allocated to any specific borrowings. The remaining expenditure is allocated to general borrowings

Analysis of expenditure

(Amounts in Rs.)

	Amount	**Amount allocated to specific borrowing**	**Amount allocated to general borrowing**	**Weighted for period outstanding**
01-Apr-19	5,00,000	5,00,000	-	-
30-Jun-19	10,00,000	2,00,000	8,00,000	6,00,000*
31-Dec-19	15,00,000	-	15,00,000	3,75,000**
31-Mar-20	5,00,000	-	5,00,000	-
Total	**35,00,000**	**7,00,000**	**28,00,000**	**9,75,000**

Specific borrowings of Rs. 7,00,000 are fully utilised; remainder of expenditure is therefore allocated to general borrowings.

* Rs. 8,00,000 x 9 months / 12 months = Rs. 6,00,000/-

** Rs. 15,00,000 x 3 months / 12 months = Rs. 3,75,000/-

Capitalisation rate

The capitalisation rate relating to general borrowings (12% Debentures and 10% Bonds) 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:

Therefore, based on the above guidance the interest to be capitalised is computed as follows:

Computation of Capitalisation rate:

$$\frac{(\text{Amount of borrowing}_1 \times \text{Interest rate}_1) + (\text{Amount of borrowing}_2 \times \text{Interest rate}_2)}{\text{Total amount of borrowings outstanding during the year}} \times 100$$

$$= \frac{(20{,}00{,}000 \times 12\%) + (20{,}00{,}000 \times 10\%)}{(20{,}00{,}000 + 20{,}00{,}000)} \times 100 = 11\%$$

Borrowing cost to be capitalised	**(Rs.)**
On Specific loan	70,000
Less: Income earned on specific borrowings	(20,000)
	50,000
On General borrowings (9,75,000*11%)	**1,07,250**
Amount eligible for capitalisation	**1,57,250**

Therefore, the borrowing costs to be capitalised are Rs. 1,57,250

Question 7

H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 2020. However, decoration work is under process which is expected to be completed by November 2020 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalise the eligible borrowing costs incurred up to November 2020.

Response

Paragraph 22 and 23 of Ind AS 23 states as follows:

"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.

23 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. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are

outstanding, this indicates that substantially all the activities are complete."

In accordance with the above, the capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalise borrowing costs only up to May 31, 2020. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on May 31, 2020. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 2020.

Question 8

ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalisation of borrowing cost should continue for the whole park until construction continues?

Response

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use. The guidance regarding capitalising borrowing costs in such scenario is provided in paragraph 24 of Ind AS 23 which states as follows:

"24 Where 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."

The cessation of capitalisation depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalised for the three-fourth part of the project.

Question 9

As part of the capital management process of XYZ Ltd., all specific borrowings for projects in excess of the current requirements of the company, are deposited into the cash credit account of the company to reduce the overdraft balance. The company proposes to capitalise the interest on these borrowings. Should saving of interest on the cash credit account be deducted from the borrowing costs before capitalisation?

Response

Paragraph 12 of Ind AS 23 states that:

"12 To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings."

In the given case, the company has no income from the temporary investment of funds as such. There is only a saving in interest cost that would have been otherwise incurred on cash credit account.

In the absence of any specific provision to this effect, such saving should not be construed as "income" from the temporary investment of borrowings. Consequently, the saving of interest on cash credit account should not be deducted from the borrowing costs for the purpose of capitalisation.

In view of paragraph 14 of Ind AS 23, it should, however, be ensured that the amount of borrowing costs that XYZ Ltd. capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

Question 10

XYZ Ltd. has completed the construction of a building (a qualifying asset) but is not permitted to use it until certain safety approvals are obtained as per the government regulations. Should capitalisation of borrowing costs be continued when the qualifying asset has been constructed and is ready for

use but is not permitted to be used until safety approvals are obtained?

Response

As per paragraph 22 of Ind AS 23:

"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".

Further, paragraph 23 explains that:

"23 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. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete."

It is pertinent to note that an asset can be considered to be ready for its intended use only on receipt of approvals and after compliance with regulatory requirements such as in case of building obtaining certificates like "Occupancy Certificate" or "Fire Clearances" etc. These are very important to declare the asset as ready for its scheduled operation.

In the given case, obtaining the safety approval is a necessary condition that needs to be complied with strictly and before obtaining the same the entity will not be able to use the building, accordingly, it is appropriate to continue capitalisation until the said approvals are obtained subject to there being no abnormal delay in seeking these approvals.

Question 11

An enterprise has constructed a complex piece of equipment (qualifying asset) that is to be installed on the production line of a manufacturing plant. The equipment has been constructed over a period of 15 months. However, on installation, certain calibrations are required to achieve the desired level of production before it is finally commissioned. This process is expected to take approximately 2 months during which test runs will be met.

Should the borrowing costs pertaining to the 2 months period be capitalised?

Response

As per paragraph 22 of Ind AS 23:

"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."

On installation of the equipment, an evaluation has to be made to conclude whether substantially all the activities necessary to prepare the asset are complete. After an equipment has been installed it is usually tested and adjusted for commercial production before it is finally commissioned. The calibrations and adjustments required during this period are performed in order to bring the equipment up to the stage at which it is ready to commence commercial production.

Until the asset reaches the stage when it is ready to support commercial levels of production, it is not appropriate to conclude that substantially all the activities necessary to prepare the asset are completed. Thus, the borrowing costs incurred during the normal period of test runs (after the installation) are capitalised.

Accordingly, in the given case, borrowing costs pertaining to the 2 months period should be capitalised.

Question 12

S Ltd. financed the construction of a qualifying asset with an inter-company loan taken from its parent company P Ltd. with an interest rate of 7% p.a. P Ltd. in-turn has obtained the said loan from a Bank at the same rate of interest of 7% p.a. for the specific purpose of providing it to S Ltd. Since, the qualifying asset is in the subsidiary company and the borrowings in the parent company, how is this treated in the financial statements as per Ind AS 23?

Response

In the separate financial statements of:

- the subsidiary S Ltd., the borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary;
- the parent company P Ltd., the parent recognises only the inter-company loan given to the subsidiary. There is no qualifying asset in the separate financial statements of P Ltd., so the borrowing costs cannot be capitalised in the separate financial statements of the parent company P Ltd.

In the consolidated financial statements of the parent P Ltd., capitalisation of borrowing costs is required. However, the amount of the borrowing costs incurred by the subsidiary in the case of inter-company loans should 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 Ind AS 23 cannot exceed the amount of borrowing costs incurred by the group.

In the given case, since the parent has taken specific borrowing for the purpose of lending it to subsidiary at the same rate of interest, hence the borrowing cost will not be required to be adjusted and will be the same as incurred by P Ltd.

Question 13

Z Ltd. commenced construction of a manufacturing plant which takes 3 years to be ready for its intended use. It incurred expenditure for the manufacturing plant but halfway through the construction, it availed a general loan from Bank and utilised the funds from such loan to incur expenditure for construction of the manufacturing plant. The manufacturing plant meets the definition of a qualifying asset as per Ind AS 23. Z Ltd. incurs expenditures on the qualifying asset both before and after it incurs borrowing costs on the general borrowings. Whether Z Ltd. should include expenditures on construction of the plant incurred before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalisation?

Response

Paragraph 17 of Ind AS 23 states that:

"17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first

meets all of the following conditions:

(a) it incurs expenditures 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."

Based on the above, it can be interpreted that in order to capitalise the borrowing costs incurred to finance a qualifying asset, the entity must:

(a) incur actual expenditures for the asset;

(b) incur actual borrowing costs to finance the said qualifying asset; and

(c) undertake such activities that are necessary to prepare the asset for its intended use or sale.

Therefore, the entity would not begin capitalising borrowing costs until it incurs borrowing costs. Once the entity incurs borrowing costs and therefore satisfies all three conditions in paragraph 17 of Ind AS 23, it then applies paragraph 14 of Ind AS 23 to determine the expenditure on the qualifying asset to which it applies the capitalisation rate. However, the entity Z Ltd. should apply the capitalisation rate on all the expenditure incurred towards the construction of the manufacturing plant even if the expenditure was incurred prior to availing the loan for financing the construction of the manufacturing plant.

In view of paragraph 14 of Ind AS 23, it should, however, be ensured that the amount of borrowing costs that Z Ltd. capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

Question 14

C Ltd. a real estate developer entity constructs the building and sells the individual units in the building to customers. It undertook a project to develop a residential building and borrows funds specifically for the purpose of constructing the building and incurs borrowing costs in connection with that borrowing. Due to high demand for residential flats, C Ltd. was able to sell some of the units in the building to customers even before the construction commenced. For the rest of the unsold units, it intends to enter into a contract to sell as soon as it finds a suitable buyer.

The terms of, and relevant facts and circumstances relating to, the C Ltd.'s contracts with customers (for both the sold and unsold units) are such that, applying paragraph 35(c) of Ind AS 115, *Revenue from Contracts with Customers*, the entity transfers control of each unit over time and, therefore, recognises revenue over time. The consideration promised by the customer in the contract is in the form of cash or another financial asset.

Whether C Ltd. has a qualifying asset as defined in Ind AS 23 and, therefore, capitalises any directly attributable borrowing costs to the asset?

Response

According to paragraph 8 of Ind AS 23:

"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."

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'.

An entity shall assess if the underlying asset meets the definition of qualifying asset for capitalising borrowing costs. Based on facts and circumstances of each case, the underlying asset may be:

a) an unsold inventory;

b) a receivable where entity has transferred fully constructed property;

c) a contract asset where entity is in the process of completing construction.

In the given case,

a) Unsold inventory is not a qualifying asset as it may be sold in the current condition (even partly constructed unit)

b) Receivable, being a financial asset is not a qualifying asset (Paragraph 7 of Ind AS 23)

c) Contract asset (as defined in Ind AS 115) representing entity's right to receive consideration that is conditional on something other than

the passage of time in exchange for transferring control of a unit. The intended use of the contract asset to collect cash or another financial asset is not a use for which it necessarily takes a substantial period of time to get ready.

Accordingly, in the given case, the entity does not have a qualifying asset and hence no borrowing cost is eligible for capitalisation as per Ind AS 23.

Question 15

X Ltd. acquires and develops a piece of land. After the development of the land, X Ltd. commences construction of a building on the piece of land. To finance both the activities, X Ltd. relies on its general borrowings. Both the land and the building meet the definition of a qualifying asset. Developing the piece of land and the construction of the building on the land, both the activities take a substantial period of time for its completion. Can X Ltd. continue to capitalise the borrowing costs incurred is respect of the expenditure incurred for developing the land while it constructs a building on the same land?

Response

The guidance on cessation of capitalisation of borrowing costs has been provided in paragraph 22 of Ind AS 23 which states that:

"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."

Therefore, to determine when to cease capitalising borrowing costs incurred on land expenditure an entity considers the intended use of the land. The intended use of land cannot be said to be solely for the purpose of construction of a building. The land and building together may be used for:

a) conducting the business activities of the entity from that premises in which case such land and building will be recognised as Property, Plant and Equipment under Ind AS 16;

b) earning rent revenue or capital appreciation in which case the land and the building will be recognised as Investment Property under Ind AS 40; or

c) for sale in which case the land and building will be recognised as

inventory under Ind AS 2.

Further, paragraph 19 and 24 of Ind AS 23 states as follows:

"19 The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They 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. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

24 Where 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."

It should be assessed whether the land (part of qualifying asset) is capable of being used for its intended purpose while construction of the building continues. If the land is not capable of being used for its intended purpose while construction of the building continues, then the land and building should be considered together to assess when to cease capitalising borrowing costs on the land expenditures.

In the given case, X Ltd. shall cease capitalising borrowing costs when it completes substantially all activities necessary to prepare land for its intended use and for this purpose the land can be said to be ready for its intended use or sale when it substantially completes all the activities necessary to prepare both the land and building for that intended use or sale

Thus, X Ltd. should continue to capitalise borrowing costs incurred on the expenditure for developing land while it constructs the building on it.

Question 16

MNO Ltd. which is a wholly owned subsidiary of a listed Government

company is in the business of exploration and production of oil and gas and other hydrocarbon related activities outside India. The overseas oil and gas operations are generally conducted in joint ventures with other partners. MNO Ltd. acquires oil and gas properties/blocks by way of acquisition of participating interest (PI) in these joint ventures through acquiring shares of an overseas subsidiary company which ultimately holds the PI in the same oil and gas joint venture project.

The company had financed the above acquisition in the oil and gas joint venture project partly by external borrowings and partly by internal accruals. The project is currently under development and would be taking substantial time for commencement of oil and gas production.

Whether the borrowing cost incurred in acquiring interest in the oil and gas joint venture project be capitalised as per Ind AS 23?

Response

As per paragraph 5 of Ind AS 23:

"A *qualifying asset* is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale."

Paragraph 7 of Ind AS 23 provides that:

"7 Depending on the circumstances, any of the following may be qualifying assets:

(a) inventories

(b) manufacturing plants

(c) power generation facilities

(d) intangible assets

(e) investment properties

(f) bearer plants.

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

Paragraph 8 of Ind AS 23 states that:

"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."

Paragraph 17 of Ind AS 23 states that:

"17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

a) it incurs expenditures 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."

In the given case, the company is acquiring the oil and gas assets through subsidiary, the company is acquiring only the investment in overseas subsidiary and not the qualifying asset (viz., oil and gas asset) as such and accordingly, considering the above requirements, borrowing costs incurred on such acquisitions cannot be capitalised in the separate financial statements of the company. Since the capitalised asset itself does not appear in the books of the company, the question of capitalisation of borrowing costs with such asset does not arise in the separate financial statements of the company.

It may be noted that as per the above reproduced principles of Ind AS 23, borrowing costs can be capitalised only when all the conditions as per paragraph 17 of Ind AS 23, are satisfied.

Question 17

S Ltd. (subsidiary co.) obtained an interest-free loan from P Ltd. (parent co.) and used it for the construction of a qualifying asset. P Ltd. arranged for the said money by obtaining loan from a bank. S Ltd. is required to repay back the loan to P Ltd. after 3 years. S Ltd. initially recognised this loan as a financial liability at fair value in accordance with Ind AS 109, *Financial Instruments*. S Ltd. has recognised the difference between the fair value of the loan (as per Ind AS 109) and the funds received from P

Ltd. as 'equity' contribution from P Ltd. in its separate financial statements. Whether S Ltd. can capitalise the interest accrued determined using the effective interest rate method as borrowing costs as per Ind AS 23?

Response

Paragraph 6 of Ind AS 23 provides that:

"6 Borrowing costs may include:

(a) interest expense calculated using the effective interest method as described in Ind AS 109, *Financial Instruments*;

(b) [Refer Appendix 1]

(c) [Refer Appendix 1]

(d) [4]interest in respect of lease liabilities recognised in accordance with Ind AS 116, *Leases*; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs"

In the given case, the loan liability will be subsequently measured at amortised cost, with interest accrued using the effective interest rate method as per Ind AS 109. In accordance with paragraph 6(a) of Ind AS 23, the interest determined using the effective interest method is an element of the borrowing costs and should be considered for determining the costs eligible for capitalisation in separate financial statements of S Ltd.

Question 18

Z Ltd. issued preference shares that are mandatorily redeemable at par in 10 years to raise funds of Rs. 10,00,000 for the purpose of obtaining a qualifying asset. It carries cumulative 10 per cent dividend payments to be made annually. Provided that 10 per cent is the market rate of interest for this type of instrument when issued, Z Ltd. has assumed a contractual obligation to make a future stream of 10 per cent interest payments. Z Ltd. has classified the preference shares as financial liability as per Ind AS 32, *Financial Instruments: Presentation.*

Whether Z Ltd. can capitalise dividend payable to preference shareholders as borrowing costs as per Ind AS 23?

[4] Substituted vide Notification No. G.S.R. 273(E) dated 30th March, 2019.

Response

As per paragraph 5 of Ind AS 23:

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

Many entities issues preference shares to finance their operations. Under Ind AS, the liability vs. equity classification of these shares is decided based on principles laid down in Ind AS 32, *Financial Instruments: Presentation*. The accounting treatment of dividends depends on the classification of preference shares. When preference shares are classified as a liability, dividends in substance represent interest costs and are included in borrowing costs. For preference shares classified as equity, dividends are not included in borrowing costs.

Accordingly, in the given case, since the preference shares have been classified as liability, accordingly Z Ltd. should capitalise the amount of dividend which is in substance interest charge as part of the borrowing cost.

Question 19

R Ltd. obtained borrowings amounting Rs. 50,00,000 with a rate of interest of 10 per cent p.a. from a bank generally to finance its operations. It used part of the said funds to obtain a qualifying asset and some part to meet its other requirements. After a few months, R Ltd. invested temporarily the excess cash that it had and earned income from it. Management of R Ltd. is of the view that it can deduct investment income from the borrowing costs available for capitalisation?

Whether income from the temporary investment of excess cash be reduced from the borrowing costs on general borrowings that are eligible for capitalisation?

Response

Paragraph 12 of Ind AS 23 states that:

"12 To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings."

The above paragraph explicitly requires that the amount of borrowing costs eligible for capitalisation is determined after deducting any investment income of specific borrowings. However, paragraph 14 of Ind AS 23, which deals with capitalisation of borrowing costs on general borrowings, does not provide for the same. There is no specific guidance given in Ind AS 23 about general borrowings, unlike specific borrowings. The funds invested 'temporarily' cannot be considered to be those from the general borrowings rather these could be from other sources (e.g. equity or cash generated from operating activities). It cannot therefore be demonstrated that the income is earned from the general borrowings.

Accordingly, income from the temporary investment of excess cash should not be deducted from the borrowing costs eligible for capitalisation in case of general borrowings.

Question 20

Zebra Ltd. uses its own cash resources to finance the construction of a qualifying asset. It did not borrow any funds. Management of A Ltd. is of the view that interest that could have been earned on the cash that has been used for the qualifying asset represents forgone benefit and could be capitalised as Borrowing costs as per Ind AS 23? Whether the contention of the management is correct?

Response

As per paragraph 5 of Ind AS 23:

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

Further paragraph 3 of Ind AS 23 states that:

"3 The Standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability."

The Standard uses the term 'incurs' and hence the amount that can be capitalised is the actual borrowing costs incurred by an entity. 'Notional' borrowing cost cannot be capitalised as per Ind AS 23.

Hence, in the given case, Z Ltd. cannot capitalise the 'Notional' borrowing cost or foregone interest income that could have been earned by investing

the excess cash instead of using it for the construction of a qualifying asset.

Question 21

XYZ Ltd. is engaged in the business of construction and development of Shopping Malls and leasing out shops/spaces in the mall to customers. It has an ongoing project of construction of a mall in Kolkata for which it has borrowed Rs. 75 crores from a bank to meet the project expenses. The project of construction of mall meets the definition of a qualifying asset as per Ind AS 23. Please suggest appropriate accounting treatment with regard to capitalisation of borrowing costs in the following scenarios:

(a) The construction of the Mall was suspended for a period of 10 days on completion of each floor for the concrete to settle. Further, there was a delay of two months due to extreme floods in Kerala during which the active development of the project (Mall) was interrupted.

There was a further delay of 15 days (with such delay being considered as normal part of the construction) in completion due to rectification of the faulty electric wirings which was discovered during final inspection. When should the capitalisation of borrowing cost related to the construction of the mall be suspended?

(b) The development of the project of construction of the Mall comprised of five phases. XYZ Ltd. has substantially completed all the work with regard to Phase I, II and III on March 5, 2019 and with regard to Phase IV and Phase V on March 20, 2019. Each phase wise construction is capable of being leased out independently, irrespective of the completion of construction of other phases. XYZ Ltd. expects that minor modifications may be required to be done based on customers specifications.

It actually carries out minor modifications based on specifications of the lessee and handed over the shops to lessees of Phase I, II and III on April 10, 2019 and to the lessees of Phase IV and V on April 15, 2019.

When should XYZ Ltd. cease to capitalise the borrowing costs incurred with respect to the Mall?

Response

(a) The guidance regarding suspension of capitalisation of borrowing

costs has been provided in paragraph 20 which states as:

"20 An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset."

Further, as per paragraph 21, an entity does not suspend capitalisation of borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. Delays due to suspension of construction for settlement of concrete (10 days) or rectification of faulty electric wirings (15 days) are necessary and/or normal for getting the asset ready for its intended use and accordingly borrowing costs should not be suspended during this period.

In the given case, the XYZ Ltd suspended the active development of the Mall for extended periods during the floods (which are not common in the area) for 2 months and therefore, the borrowing costs will be suspended to be capitalised only during those 2 months.

(b) In the given case, XYZ Ltd. is constructing a mall in phases and each constructed part as completed in a phase is capable of being leased out. Further on completion of construction of the shops, it makes minor changes to the shops for leasing them out to its customer.

The guidance on cessation of capitalisation of borrowing costs has been provided in paragraphs 22, 23 and 24 of Ind AS which states as:

"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.

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

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."

Accordingly, XYZ Ltd. should cease to capitalise the borrowing costs for phase I, II & III on March 5, 2019 and for phase IV & V on March 20, 2019 i.e., when the construction of the asset is complete and it is ready for its intended use. The fact that minor changes are expected to be made later as per the specification of the customers should not be considered as all the substantial activities have been completed in March 2019.

Appendix I

Note: The purpose of this Appendix is only to bring out the major differences, if any, between Indian Accounting Standard (Ind AS) 23, Borrowing Costs and Accounting Standard (AS) 16, Borrowing Costs

Major differences between Ind AS 23, *Borrowing Costs* and AS 16*, Borrowing Costs*

(i) Ind AS 23 does not require an entity to apply this standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value, for example, a biological asset whereas AS 16 does not provide for such scope exclusion.

(ii) Ind AS 23 also does not require application of this Standard to borrowing costs directly attributable to the acquisition, construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis whereas AS 16 does not provide for such scope exclusion and is applicable to borrowing costs related to all inventories that require substantial period of time to bring them in saleable condition.

(iii) As per AS 16, *Borrowing Costs*, *inter alia*, include the following:

(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings.

Ind AS 23 requires to calculate the interest expense using the effective interest rate method as described in Ind AS 109. Items (b) and (c) above are not mentioned in Ind AS 23, as some of these components of borrowing costs are considered as the components of interest expense calculated using the effective interest rate method. Also, Ind AS 23 includes interest in respect of lease liabilities (recognised as per Ind AS 116), while, AS 16 includes finance charges in respect of assets acquired under finance lease as part of borrowing costs.

Ind AS 23 provides that where there is an unrealised exchange loss

which is treated as an adjustment to interest and subsequently there is a realised or unrealised gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognised as an adjustment should also be recognised as an adjustment to interest. AS 16 does not explicitly deal with such scenario.

(iv) AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term 'qualifying asset' as twelve months whereas under Ind AS 23, there is no such explanation.

(v) Ind AS 23 provides that when Ind AS 29, *Financial Reporting in Hyperinflationary Economies,* is applied, part of the borrowing costs that compensates for inflation should be expensed as required by that Standard (and not capitalised in respect of qualifying assets). AS 16 does not contain a similar clarification because at present, in India, under AS regime, there is no Standard on *Financial Reporting in Hyperinflationary Economies.*

(vi) Ind AS 23 specifically provides that in some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs while in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. This specific provision is not there in AS 16.

(vii) Ind AS 23 requires disclosure of capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation. AS 16 does not have this disclosure requirement.

(viii) For the purpose of computing borrowing cost under Ind AS 23 in regard to foreign currency borrowing, the difference is to be computed with reference to functional currency whereas under AS 16 read with AS 11, the difference is between the local currency and foreign currency.

Appendix II

Note: The purpose of this Appendix is only to bring out the major differences, if any, between Indian Accounting Standard (Ind AS) 23, Borrowing Costs and the corresponding International Accounting Standard (IAS) 23, Borrowing Costs issued by the International Accounting Standards Board.

Major differences between Ind AS 23, *Borrowing Costs* and IAS 23, *Borrowing Costs*

IAS 23 provides no guidance as to how the adjustment prescribed in paragraph 6(e) is to be determined. Ind AS 23 provides guidance (paragraph 6A) in this regard.