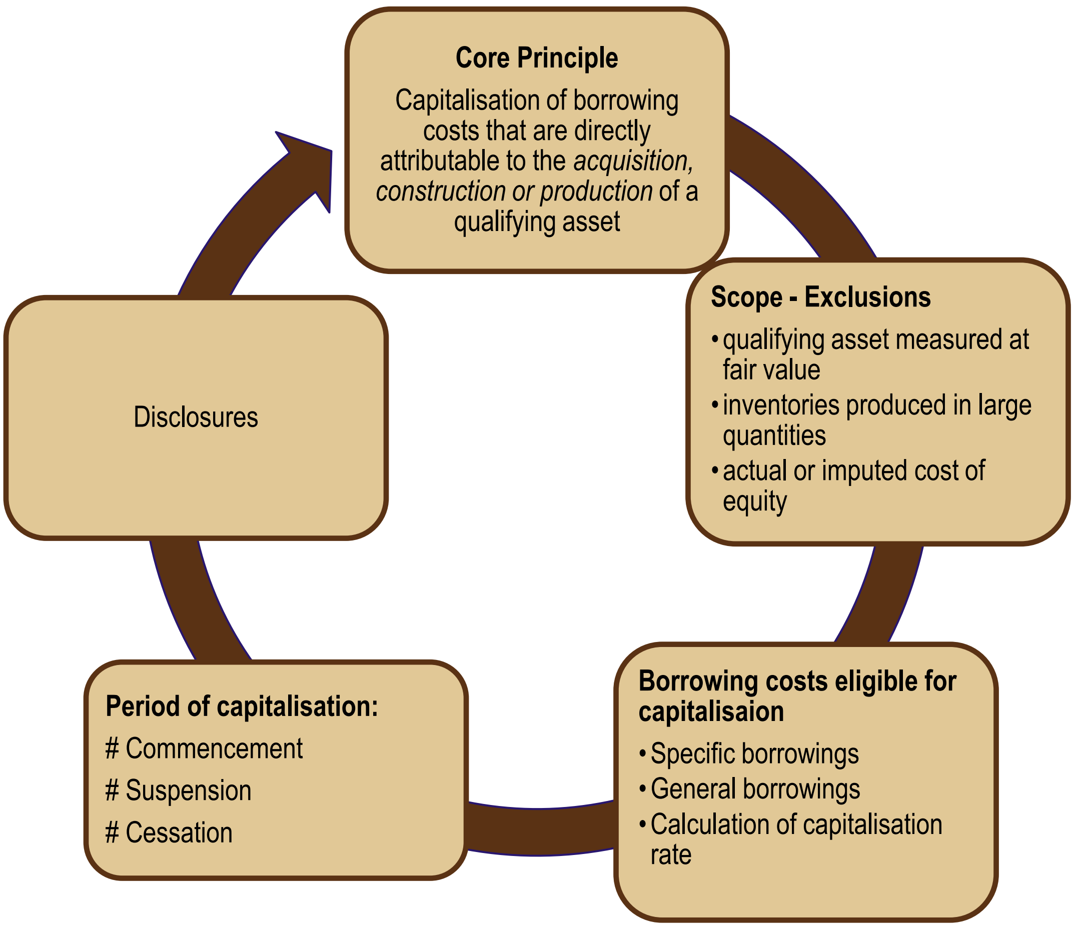
UNIT 3 : INDIAN ACCOUNTING STANDARD 23 : BORROWING COSTS

LEARNING OUTCOMES

After studying this unit, you will be able to:

- Identify the core principle and scope of the standard
- Define borrowing cost, qualifying asset and other related terms
- Examine various conditions and pre-conditions for capitalisation of borrowing costs
- Recognize suspension and cessation of capitalization of borrowing cost
- Comply with the disclosure requirements of the standard
- Differentiate between Ind AS 23 and AS 16.

UNIT OVERVIEW

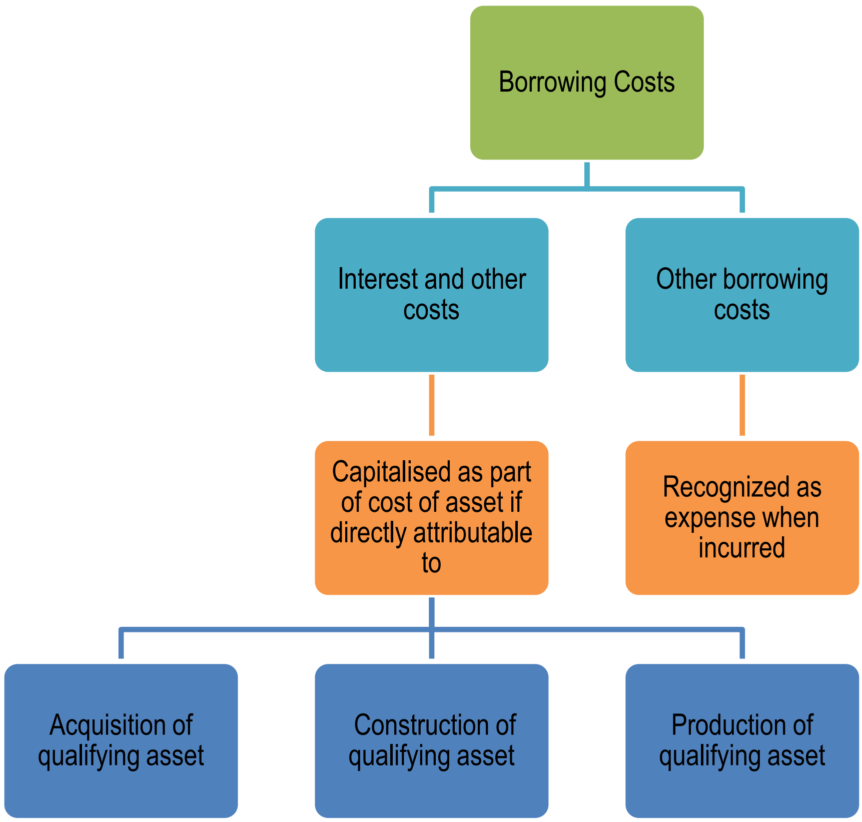


3.1 CORE PRINCIPLE

The core principle of Ind AS 23 states that:

a. Borrowing costs that are directly attributable to the *acquisition, construction or production* of a qualifying asset are included in the cost of that asset i.e. must be capitalised.

b. Other borrowing costs are recognized as an expense in the period in which they are incurred.



3.2 SCOPE OF THE STANDARD

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

Example 1

Dividend paid on equity shares, cost of issuance of equity shares, cost of preference share capital (not classified as liability as per Ind AS 32) will not be included as borrowing cost within the purview of this standard.

- The general requirement of this standard (to capitalise directly attributable borrowings cost) is not required to be applied to:

  (a) **qualifying assets that are measured at fair value, for example, a biological asset accounted for under Ind AS 41** - If the assets are held under fair value model with all changes going to statement of profit or loss, then capitalisation would not affect measurement in the balance sheet and would involve only reallocation between finance cost and fair value movement in the Statement of profit and loss.

  (b) **inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis** – This exemption acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventories are sold.

3.3 KEY DEFINITIONS

Following are the terms defined in the standard:

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

   - interest expense calculated using the effective interest rate method as described in Ind AS 109 *Financial Instruments;*
   - interest in respect of lease liabilities recognized 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

Interest expense
- Calculated using the effective interest method as described in Ind AS 109

Interest in respect of lease liabilities
- Recognized in accordance with Ind AS 116

Exchange differences arising from foreign currency borrowings
- Recognized to the extent that they are regarded as an adjustment to interest costs

2. **Qualifying asset:** Qualifying asset is 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 etc.

Ind AS 23 does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

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.

Qualifying asset

- Takes substantial period of time to get ready for its intended use or sale.

Includes

- Inventories
- Manufacturing plant
- Power generation facilities
- Intangible assets
- Bearer plants

Excludes

- Inventories produced in large quantities on repititive basis
- Assets ready for intended use or sale when acquired
- Financial assets

Illustration 1

A company deals in production of dairy products. It prepares and sells various milk products like ghee, butter and cheese. The company borrowed funds from bank for manufacturing operation. The cheese takes substantial longer period to get ready for sale.

State whether borrowing costs incurred to finance the production of inventories (cheese) that have a long production period, be capitalised?

Solution

Ind AS 23 does not require the capitalisation of borrowing costs for inventories that are manufactured in large quantities on a repetitive basis. However, interest capitalisation is permitted as long as the production cycle takes a 'substantial period of time', as with cheese.

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Illustration 2

A company is in the process of developing computer software. The asset has been qualified for recognition purposes. However, the development of computer software will take substantial period of time to complete.

(i) Evaluate whether computer software can be termed as a 'qualifying asset' under Ind AS 23?

(ii) Analyse whether management intention should be considered for assessment of the asset as a qualifying asset?

Solution

(i) 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 computer software in the development phase when it takes a 'substantial period of time' to complete.

(ii) 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.

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Illustration 3

A telecom company has acquired a 3G license. 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 license is acquired.

Identify whether the borrowing costs on the acquisition of the 3G license be capitalised until the network is ready for its intended use.

Solution

Yes. The license has been exclusively acquired to operate the wireless network. The fact that the license can be used or licensed to a third party is irrelevant. The acquisition of the license 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 Ind AS 23.

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Illustration 4

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.

Examine whether the borrowing costs on the acquisition of the permit and the equipment be capitalised until the construction of the building is complete.

Solution

With respect to Permit

Yes, since permit 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.

With respect to Equipment

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

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Illustration 5

Is interest on a lease of a qualifying asset capitalised as borrowing costs?

Solution

Yes, interest incurred for a lease is specific to an asset. Interest is capitalised if the asset is a qualifying asset or is used solely for the construction of a qualifying asset. For example, a crane or a dockyard is leased for the purpose of constructing a ship. The ship is a qualifying asset. The interest on the lease of the crane or dockyard is capitalised as borrowing costs. Borrowing costs on the lease can only be capitalised up to the point when the construction of the qualifying asset is complete.

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3.4 EXCHANGE DIFFERENCE TO BE INCLUDED IN BORROWING COSTS

The extent to which exchange differences can be considered as borrowing cost depends on the terms and conditions of the foreign currency borrowing.

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. An entity may borrow funds in a currency that is not its functional currency e.g. A Company with INR functional currency may take US dollar loan for financing asset development project in a company.

This may have been done on the basis that, over the period of the development of asset, the borrowing costs, even after allowing for exchange differences, were expected to be less than the interest cost of an equivalent INR loan.

Following approach is to be followed for determining the extent to which the exchange difference should be treated as borrowing costs:

(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 a foreign currency.

Example 2

An entity can borrow funds in its functional currency (₹) @ 12%. It borrows $ 1,000 @ 4% on 1st April, 20X1 when $ 1 = ₹ 40. The equivalent amount in functional currency is ₹ 40,000. Interest is payable on 31st March, 20X2. On 31st March, 20X2, exchange rate is $ 1 = ₹ 50. The loan is not due for repayment. The exchange loss in this case is ₹ 10,000 [$ 1,000 x (₹ 50- ₹ 40)]. The borrowing cost is ₹ 2,000 ($ 1,000 x 4% x ₹ 50).

Had the entity borrowed funds in functional currency the borrowing cost would have been ₹ 4,800 (₹ 40,000 x 12%).

The entity will treat exchange difference upto ₹ 2,800 (₹ 4,800 – ₹ 2,000) as a borrowing cost that may be eligible for capitalisation under this Standard.

Thus, the total eligible borrowing cost is ₹ 4,800 (₹ 2,000 + ₹ 2,800) equivalent to the borrowing cost in functional currency.

If the exchange rate on 31st March, 20X2, is $ 1 = ₹ 41. The exchange loss is ₹ 1,000 [$ 1,000 – (₹ 41 – ₹ 40)]. The entity will treat the entire exchange loss as an eligible borrowing cost as total cost of the borrowing ₹ 2,640 [(₹ 1,000 x 4% x 41) + ₹ 1,000] in foreign currency does not exceed the cost of borrowings in functional currency, i.e., ₹ 4,800.

(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 recognized as an adjustment should also be recognized as an adjustment to interest.

Example 3: Continuing with the aforesaid example 2:

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 48; the exchange rate on 31st March, 20X2, being $ 1= ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,920 ($ 1,000 x 4% x ₹ 48). There is an exchange gain of ₹ 2,000 ($ 1,000 x (₹ 50 – ₹48)). This will be adjusted in the borrowing cost as there is unrealized exchange loss and the adjustment is less than the exchange loss of ₹ 2,800 recognized in earlier year.

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50, the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 1,760 ($ 1,000 x 4% x ₹ 44). There is an exchange gain of ₹ 6,000 [$ 1,000 x (₹ 50 – ₹ 44)]. This will be adjusted in the borrowing cost upto ₹ 2,800 as there is unrealized exchange loss and the adjustment of the exchange loss recognized in earlier years is of ₹ 2,800.

If the exchange rate on 31st March, 20X3, is $ 1 = ₹ 44 and part of loan is repaid; the exchange rate on 31st March, 20X2, being $ 1 = ₹ 50; $ 600 of the borrowings was paid on 31st March, 20X2, $ 400 of the borrowings are still not due for payment. The entity will recognize a borrowing cost of ₹ 704 ($ 400 x 4% x ₹ 44). There is an exchange gain of ₹ 2,400 [$ 400 x (₹ 50 – ₹ 44)]. The unrealised exchange loss of earlier year is ₹ 4,000 [$ 400 x (₹ 50 – ₹ 40)] out of which ₹ 1,120 (₹ 2,800 x $ 400 / $ 1000) was charged in 31st March, 20X2, as borrowing cost. Thus, there will be an adjustment in the borrowing cost upto ₹ 1,120 as this is unrealised exchange loss.

Illustration 6

ABC Ltd. has taken a loan of USD 20,000 on 1st April, 20X1 for constructing a plant at an interest rate of 5% per annum payable on annual basis.

On 1st April, 20X1, the exchange rate between the currencies i.e. USD vs Rupees was ₹ 45 per USD. The exchange rate on the reporting date i.e. 31st March, 20X2 is ₹ 48 per USD.

The corresponding amount could have been borrowed by ABC Ltd. from State Bank of India in local currency at an interest rate of 11% per annum as on 1st April, 20X1.

Compute the borrowing cost to be capitalized for the construction of plant by ABC Ltd. for the period ending 31st March, 20X2.

Solution

In the above situation, the borrowing cost needs to determine for interest cost on such foreign currency loan and eligible exchange loss difference if any.

(a) Interest on foreign currency loan for the period:

USD 20,000 x 5% = USD 1,000

Converted in ₹: USD 1,000 x ₹ 48/USD = ₹ 48,000

(b) Interest that would have resulted if the loan was taken in Indian Currency:

USD 20,000 x ₹ 45/USD x 11% = ₹ 99,000

(c) Difference between interest on foreign currency borrowing and local currency borrowing:

₹ 99,000 - 48,000 = ₹ 51,000

Increase in liability due to change in exchange difference: USD 20,000 x (48 - 45) = ₹ 60,000

Hence, out of exchange loss of ₹ 60,000 on principal amount of foreign currency loan, only exchange loss to the extent of ₹ 51,000 is considered as borrowing costs.

Total borrowing cost to be capitalized is as under:

(a)	Interest cost on borrowing	₹ 48,000
(b)	Exchange difference to the extent considered to be an adjustment to Interest cost	₹ 51,000
		₹ 99,000

The exchange difference of ₹ 51,000 has been capitalized as borrowing cost and the remaining ₹ 9,000 will be expensed off in the Statement of Profit and Loss as finance cost.

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3.5 RECOGNITION

- Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset.
- Such borrowing cost are capitalised when below two conditions are satisfied:
  - it is probable that it will result in future economic benefits to the entity; and
  - the costs can be measured reliably.

- Other borrowing costs are recognized as an expense in the period in which they are incurred.
- When an entity applies Ind AS 29 *Financial Reporting in Hyperinflationary Economies*, it recognizes as an expense the part of borrowing costs that compensates for inflation during the same period.

3.5.1 Borrowing costs eligible for capitalisation

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.

Since it may not always be easy to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided, the standard includes separate requirements for specific borrowings and general borrowings.

3.5.1.1 Specific borrowing costs

- If an entity borrows funds specifically to obtain a qualifying asset, the borrowing costs that are directly related to that qualifying asset can be readily identified.
- The borrowings cost eligible for capitalisation would be the **actual** borrowing costs incurred during the period less any investment income on the temporary investment of those borrowings.

  Note: *A 'notional' borrowing cost cannot be capitalised.* Ind AS 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.

- An entity may obtain borrowed funds specifically and incur associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. 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.

Borrowing costs eligible for capitalisation = Actual borrowing costs incurred on that borrowing during the period − Investment income on the temporary investment **of those borrowings**, if any.

Illustration 7

Alpha Ltd. on 1st April, 20X1, borrowed ₹ 30,00,000 @ 9% to finance the construction of two qualifying assets. Construction started on 1st April, 20X1. The loan facility was availed on 1st April, 20X1 and was utilized as follows with remaining funds invested temporarily at 7%:

	Factory Building	Office Building
1st April, 20X1	5,00,000	10,00,000
1st October, 20X1	5,00,000	10,00,000

Calculate the cost of the asset and the borrowing cost to be capitalized.

Solution

Particulars	**Factory Building**	**Office Building**
Borrowing Costs	(10,00,000 x 9%) 90,000	(20,00,000 x 9%) 1,80,000
Less: Investment Income	(5,00,000 x 7% x 6/12) (17,500)	(10,00,000x7% x 6/12) (35,000)
	72,500	1,45,000
Cost of the asset:		
Expenditure incurred	10,00,000	20,00,000
Borrowing Costs	72,500	1,45,000
Total	**10,72,500**	**21,45,000**

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3.5.1.2 General borrowing costs

- All borrowings that are not specific represents general borrowings.
- When funds are borrowed specifically for a qualifying asset, costs in relation to that borrowing are accounted for as specific borrowing costs until the asset is ready for its intended use or sale; if the borrowing remains outstanding after the related asset is ready for its intended use or sale, it becomes part of 'general borrowings'.

Illustration 8

On 1st April, 20X1, A Ltd. took 8% loan of ₹ 50,00,000 for construction of building A which is repayable after 6 years ie on 31st March, 20X7. The construction of building was completed on 31st March, 20X3. A Ltd. started constructing a new building B in the year 20X3-20X4, for which he used his existing borrowings. He has outstanding general-purpose loan of ₹ 25,00,000, interest on which is payable @ 9% and ₹ 15,00,000, interest on which is payable @ 7%.

Recommend whether the specific borrowing should be transferred to the general borrowings pool once the respective qualifying asset is completed.

Solution

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).

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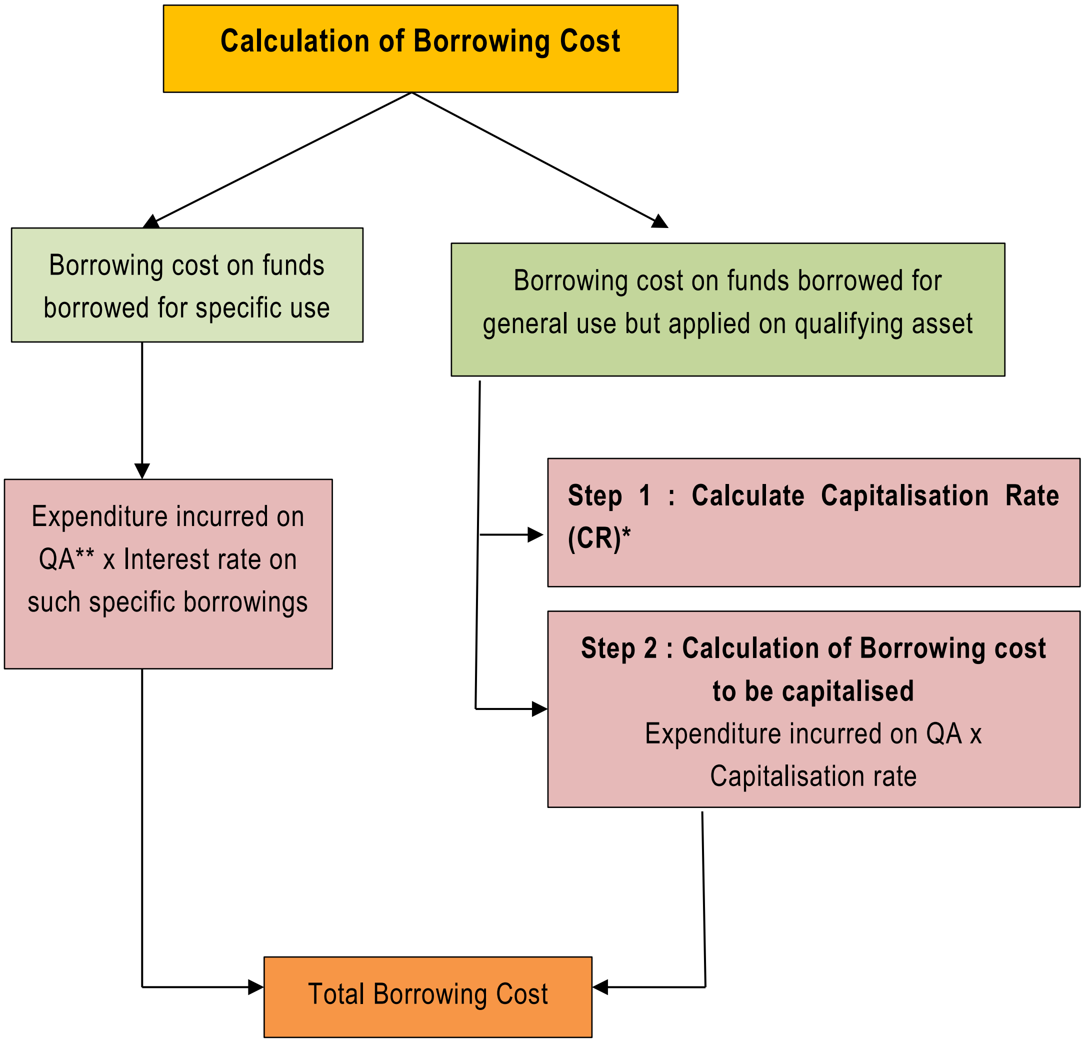
- When general borrowings are used for qualifying assets, Ind AS 23 requires that, borrowing costs eligible for capitalisation is calculated by applying a capitalisation rate to the expenditures on qualifying assets.
- The amount of borrowing costs eligible for capitalisation is always limited to the amount of actual borrowing costs incurred during the period.

3.5.2 Calculation of capitalisation rate

- When the funds are borrowed generally 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 qualifying asset.
- The capitalisation rate is the weighted average of the borrowing costs applicable to all the general borrowings of the entity that are outstanding during the period.
- Borrowing costs in respect of specific funds borrowed for the purpose of obtaining a qualifying asset shall be excluded from calculation of capitalisation rate until substantially all the activities necessary to prepare that qualifying 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.



$$*CR = \frac{\text{Weighted average borrowing costs on outstanding borrowings of the entity (excluding specific borrowings cost)}}{\text{Total outstanding borrowings of the entity during the period (excluding specific borrowings)}}$$

**QA = Qualifying Asset

Illustration 9

Beta Ltd. had the following loans in place at the end of 31st March, 20X2:

(Amounts in ₹ 000s)

Loan	1st April, 20X1	31st March, 20X2
18% Bank Loan	1,000	1,000
16% Term Loan	3,000	3,000
14% Debentures	-	2,000

14% Debentures were issued to fund the construction of office building on 1st July, 20X1 but the development activities has yet to be started.

On 1st April, 20X1, Beta Ltd. began the construction of a Plant being a qualifying asset using the existing borrowings. Expenditure drawn down for the construction was: ₹ 5,00,000 on 1st April, 20X1 and ₹ 25,00,000 on 1st January, 20X2.

Calculate the borrowing cost that can be capitalised for the plant.

Solution

Capitalisation rate	$\frac{(18\% \text{ x } 1{,}000)}{1{,}000+3{,}000}+\frac{(16\% \text{ x } 3{,}000)}{1{,}000+3{,}000}$	16.5%
Borrowing Costs	(5,00,000 x 16.5%) + (25,00,000 x16.5% x 3/12)	₹ 1,85,625

Capitalisation rate for above illustration could also be calculated with the following approach by assigning weights to the borrowings:

Particulars	Loan	Weighted average (a)	Interest rate (b)	Capitalisation rate (a*b)
18% Bank Loan	1,000	25%	18%	4.5%
16% Term Loan	3,000	75%	16%	12%
Total	**4,000**	**100%**		**16.5%**

Answer in both the approaches would be same as can be seen from the above two solutions.

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3.5.3 Expenditure to which capitalisation rate is applied

- In determining the borrowing costs to be capitalised, the amount of expenditure 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.

3.5.4 Excess of the carrying amount over recoverable amount

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards.

3.6 PERIOD OF CAPITALISATION

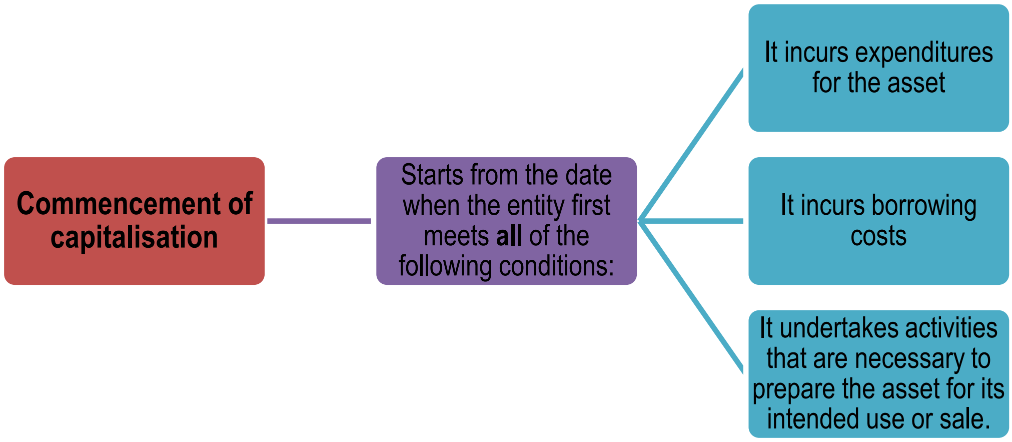
3.6.1 Commencement of capitalisation

- An entity is required to begin the capitalisation of borrowing costs as part of the cost of a qualifying asset on the commencement date.
- The commencement date is the date when the entity first meets all of the following conditions cumulatively on a particular date:

  (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.



Explanation to the three conditions for commencement date

♦ **Expenditures on a qualifying asset include:**

- Those expenditures that have resulted in payments of cash
- transfers of other assets
- assumption of interest-bearing liabilities

Expenditures are reduced by any progress payments received and grants received in connection with the asset.

♦ **Activities necessary to prepare asset for its intended use or sale:**

- Includes 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.
- excludes 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.

Illustration 10 : Commencement Date

X Ltd. is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

(i) 15th May, 20X1: Loan interest relating to the project started incurring

(ii) 2nd June, 20X1 : Technical site planning commenced

(iii) 19th June, 20X1 : Expenditure on the project started incurring

(iv) 18th July, 20X1 : Construction work commenced

Identify the commencement date for capitalisation of borrowing cost.

Solution

In the above case, the three conditions to be tested for commencement date would be:

Borrowing cost has been incurred on : 15th May, 20X1

Expenditure has been incurred for the asset on : 19th June, 20X1

Activities necessary to prepare asset for its intended use or sale: 2nd June, 20X1

Commencement date would be the date when the above three conditions would be satisfied in all i.e. 19th June, 20X1

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3.6.2 Suspension of capitalisation

- Capitalisation of borrowing costs shall be suspended during the extended periods in which the active development of a qualifying asset is suspended. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, the standard distinguishes between extended periods of interruption (when capitalisation would be suspended) and periods of temporary delay that are a necessary part of preparing the asset for its intended purpose (when capitalisation is not normally suspended).

- Capitalisation of borrowing cost is not suspended when 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, if such high-water levels are common during the construction period in the geographical region involved. Similarly, capitalisation continues during periods when inventory is undergoing slow transformation – the example is given of inventories taking an extended time to mature (presumably such products as Scotch whisky or Cognac, although the relevance of this may be limited as these products are likely to meet the optional exemption for 'routinely manufactured' products.

Example 4: Suspension of Capitalisation

(a) Construction suspended between October, 20X1 to January, 20X2 during which period certain heavy construction equipment under use was shifted to another site.

In this case, capitalization of borrowing costs needs to be suspended since active development is interrupted.

(b) When Qualifying Asset construction is about to complete, there was temporary delay of 20 days on account of some technical reasons.

In this case, capitalization of borrowing costs shall be continued.

3.6.3 Cessation of capitalisation

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

  For e.g. A business park comprising several buildings, each of which can be used individually, is a qualifying asset for which each part is capable of being usable while construction continues on other parts.

  For a qualifying asset that needs to be complete in its entirety before any part can be used as intended, it would be appropriate to capitalise related borrowing costs until all the activities necessary to prepare the entire asset for its intended use or sale are substantially complete. An example of this is an industrial plant, such as a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site.

Example 5

H Limited, a real estate company, gives immovable property on rent. It has completed on 31st May, 20X1, a commercial complex consisting of various offices that could be rented out. It expects that the commercial complex will be completely rented out by 30th June, 20X1. However, due to adverse market conditions, only 10% of the commercial complex could be rented out by its reporting date of 31st March, 20X2. H Limited wants to capitalise the eligible borrowing costs incurred up to 31st March, 20X2.

H Limited should capitalise borrowing costs only up to 31st May, 20X1. The borrowing cost incurred thereafter cannot be capitalised as the asset was ready for its intended use on 31st May, 20X1. The fact that only a small portion could be rented out by 31st March, 20X2, is not relevant.

3.7 DISCLOSURE

Entities are required to disclose:

(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

3.8 OTHER RELEVANT CONCEPTS

3.8.1 Dividends payable on shares classified as financial liabilities

- An entity might finance its operations in whole or in part by the issue of **preference shares** and in some circumstances these will be **classified as financial liabilities** (as per Ind AS 32). **Dividends payable** on these instruments would **meet the definition of borrowing costs**, subject to the fulfillment of certain conditions.

Example 6

An entity might have funded the development of a qualifying asset by issuing redeemable preference shares that are redeemable at the option of the holder and so are classified as financial liabilities under Ind AS 32. In this case, dividend would be treated as interest and meet the definition of borrowing costs and so should be capitalised following the principles on specific borrowings as discussed in a separate section 4.5.1.1 above.

3.8.2 Capitalising borrowing cost in group financial statements

- There may be a situation when the borrowings are taken by one company and qualifying asset is developed by another company within a group.
- It may be **appropriate to capitalise interest in the group financial statements** on borrowings that appear in the financial statements of a different group entity from that carrying out the development.
- Based on the underlying principle of Ind AS 23, capitalisation in such circumstances would only be appropriate if the amount capitalised fairly reflected the interest cost of the group on borrowings **from third parties** that could have been avoided if the expenditure on the qualifying asset were not made.
- However, **the entity carrying out the development should not capitalise any interest in its own financial statements** as it has no borrowings.
- If, however, the entity has **intra-group borrowings** then interest on such borrowings may be **capitalised in its own financial statements**.

Illustration 11

A subsidiary (or jointly controlled entity or associate) finances the construction of a qualifying asset with an inter-company loan. Are borrowing costs incurred on the inter-company loan capitalised in the separate financial statements of the subsidiary (or jointly controlled entity or associate)?

Solution

Yes. Borrowing costs are capitalised to the extent of the actual costs incurred by the subsidiary (or jointly controlled entity or associate).

*****

3.8.3 Cessation of capitalisation for maturing inventories

- For maturing inventories, it is sometimes difficult to determine when the 'period of production' ends, i.e. when inventories are being held for sale as opposed to being held to mature.

Example 7

Whisky is 'mature' after three years but goes on improving with age for many more years. Provided that it is consistent with the entity's business model to hold such items so that they mature further, it would seem acceptable to continue to add borrowing costs to the value of such maturing inventories for as long as it can be demonstrated that the particular item of inventory continues to increase in value solely on account of increasing age, rather than because of market fluctuations or inflation.

- If this cannot be demonstrated, then the inventories should be regarded as held for sale and no further borrowing costs should be capitalised.

3.9 EXTRACTS OF FINANCIAL STATEMENTS OF LISTED ENTITY

Following is the extract from the financial statements of the listed entity 'Larsen & Toubro Limited' for the financial year 2021-2022 with respect to 'Borrowing Costs'.

Notes:

(1) Borrowing cost capitalised in accordance with Ind AS 23 "Borrowing Costs" is as follows:

₹ crore

Class of Assets	2021-22	2020-21
Capital work-in-progress		
Property, plant and equipment - building	8.83	27.75
Investment property - building	12.63	13.11
Total	21.46	40.86

(2) The average borrowing cost used for capitalisation is 7.29% (previous year: 6.56%).

Note in Property, Plant and Equipment & Capital work-in-progress

- *Additions during the year and capital work-in-progress of buildings include ₹ 8.83 crore (previous year: ₹ 27.75 crore) being borrowing cost capitalised in accordance with Accounting Standard (Ind AS) 23 "Borrowing Costs".*
- *The rate used to determine the amount of borrowing costs eligible for capitalisation is 6.23% (previous year: 5.71%).*

ACCOUNTING POLICY
Borrowing Costs *Borrowing costs include finance costs calculated using the effective interest method, finance charges in respect of assets acquired on lease and exchange differences arising on foreign currency borrowings, to the extent they are regarded as an adjustment to finance costs. In cases where hedging instruments are acquired for protection against exchange rate risk related to borrowings and are accounted as hedging a time-period related hedge item, the borrowing costs also include the amortisation of premium element of the forward contract and foreign currency basis spread as applicable, over the period of the hedging instrument.* *Borrowing costs net of any investment income from the temporary investment of related borrowings that are attributable to the acquisition, construction or production of a qualifying asset are capitalised / inventoried as part of cost of such asset till such time the asset is ready for its intended use or sale. A qualifying asset is an asset that necessarily requires a substantial period of time to get ready for its intended use or sale. All other borrowing costs are recognized in profit or loss in the period in which they are incurred..*

(Source: Annual Report 2021-2022 - 'Larsen & Toubro Limited')

3.10 SIGNIFICANT DIFFERENCES IN IND AS 23 *VIS-À-VIS* AS 16

S. No.	Particular	Ind AS 23	AS 16
1.	*Qualifying Asset measured at Fair Value*	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	AS 16 does not provide for such scope exclusion
2.	*Applicability to Inventories*	Ind AS 23 does not require the application of this Standard to borrowing costs directly attributable to the acquisition,	AS 16 does not provide for such scope exclusion and is applicable to borrowing costs related to all

		construction or production of inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis	inventories that require substantial period of time to bring them in saleable condition
3.	*Inclusion as Borrowing Costs*	Ind AS 23 requires calculation of interest expense using the effective interest rate method as described in Ind AS 109. Items (b) and (c) are not mentioned as some of those components of borrowing costs are considered as the components of interest expense calculated using the effective interest rate method.	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
4.	*Interest on leases*	Ind AS 23 includes interest in respect of lease liabilities (recognized as per Ind AS 116)	AS 16 includes finance charges in respect of assets acquired under finance lease as part of borrowing costs
5.	*Unrealized exchange loss*	Ind AS 23 provides that where there is an unrealized exchange loss which is treated as an adjustment to interest and subsequently there is a realized or unrealized gain in respect of the settlement or translation of the same borrowing, the gain to the extent of the loss previously recognized as an adjustment should also be recognized as an adjustment to interest.	AS 16 does not explicitly deal with such scenario.
6.	*Explanation of Substantial Period of Time*	This explanation is not included in Ind AS 23.	AS 16 gives explanation for meaning of 'substantial period of time' appearing in the definition of the term

			'qualifying asset' as twelve months
7.	*Reporting in Hyperinflationary Economies*	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 capitalized in respect of qualifying assets).	AS 16 does not contain a similar clarification because at present, in India, there is no Standard on '*Financial Reporting in Hyperinflationary Economies'*.
8.	*Borrowings of the Parent and its Subsidiaries for Computing Weighted Average*	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.
9.	*Disclosure of capitalisation rate*	Ind AS 23 requires disclosure of capitalization rate used to determine the amount of borrowing costs eligible for capitalization.	AS 16 does not have this disclosure requirement.
10.	*Borrowing cost in regard to foreign currency borrowing*	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	Under AS 16 read with AS 11, the difference is between the local currency and foreign currency.

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Questions

1. Marine Transport Limited ordered 3 ships for its fleet on 1st April, 20X0. It pays a down payment of 25% of the contract value of each of the ship out of long-term borrowings from a scheduled bank. The delivery has to commence from the financial year 20X7. On 1st March, 20X2, the ship builder informs that it has commenced production of one ship. There is no progress on other 2 ships. Marine Transport Limited prepares its financial statements on financial year basis.

   Advise whether it is permissible for Marine Transport Limited to capitalise any borrowing costs for the financial year ended 31st March, 20X1 or 31st March, 20X2.

2. X Limited 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 31st March, 20X2, the Company commenced the construction of a qualifying asset and incurred the following expenses:

Date	**Amount (₹)**
1st July, 20X1	2,50,000
1st December, 20X1	3,00,000

The details of borrowings and interest thereon are as under:

Particulars	Average Balance (₹)	Interest (₹)
Long term loan @ 10%	10,00,000	1,00,000
Working capital loan	5,00,000	65,000
	15,00,000	1,65,000

Compute the borrowing costs that need to be capitalised.

3. An entity constructs a new head office building commencing on 1st September 20X1, which continues till 31st December 20X1. Directly attributable expenditure at the beginning of the month on this asset are ₹ 1,00,000 in September 20X1 and ₹ 2,50,000 in each of the months of October to December 20X1.

The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. During the year, the entity had issued 10% debentures with a face value of ₹ 20 lacs and had an overdraft of ₹ 5,00,000, which increased to ₹ 7,50,000 in December 20X1. Interest was paid on the overdraft at 15% until 1 October 20X1, then the rate was increased to 16%.

Calculate the capitalization rate for computation of borrowing cost in accordance with Ind AS 23 'Borrowing Costs'.

4. K Ltd. began construction of a new building at an estimated cost of ₹ 7 lakh on 1st April, 20X1. To finance construction of the building it obtained a specific loan of ₹ 2 lakh from a financial institution at an interest rate of 9% per annum.

The company's other outstanding loans were:

Amount	Rate of Interest per annum
₹ 7,00,000	12%
₹ 9,00,000	11%

The expenditure incurred on the construction was:

April, 20X1	₹ 1,50,000
August, 20X1	₹ 2,00,000
October, 20X1	₹ 3,50,000
January, 20X2	₹ 1,00,000

The construction of building was completed by 31st January, 20X2.

Following the provisions of Ind AS 23 'Borrowing Costs', calculate the amount of interest to be capitalized and pass necessary journal entry for capitalizing the cost and borrowing cost in respect of the building as on 31st January, 20X2.

5. On 1st April, 20X1, entity A contracted for the construction of a building for ₹ 22,00,000. The land under the building is regarded as a separate asset and is not part of the qualifying assets. The building was completed at the end of March, 20X2, and during the period the following payments were made to the contractor:

Payment date	Amount (₹ '000)
1st April, 20X1	200
30th June, 20X1	600
31st December, 20X1	1,200
31st March, 20X2	200
Total	2,200

Entity A's borrowings at its year end of 31st March, 20X2 were as follows:

a. 10%, 4-year note with simple interest payable annually, which relates specifically to the project; debt outstanding on 31st March, 20X2 amounted to ₹ 7,00,000. Interest of ₹ 65,000 was incurred on these borrowings during the year, and interest income of ₹ 20,000 was earned on these funds while they were held in anticipation of payments.

b. 12.5% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,000,000 and remained unchanged during the year; and

c. 10% 10-year note with simple interest payable annually; debt outstanding at 1st April, 20X1 amounted to ₹ 1,500,000 and remained unchanged during the year.

Determine the amount of the borrowing costs which can be capitalized at the year end as per relevant Ind AS.

6. In a group with Parent Company "P" there are 3 subsidiaries with following business:

"A" – Real Estate Company

"B" – Construction Company

"C" – Finance Company

- Parent Company 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 Company is a vehicle used by the group solely for raising finance.
- All entities in the group prepare Ind AS financial statements.

The following information is relevant for the current reporting period 20X1-20X2:

Real Estate Company

- Borrowings of ₹ 10,00,000 with an interest rate of 7% p.a.
- Expenditures on qualifying assets during the period amounted to ₹ 15,40,000.
- All construction works were performed by Construction Company. Amounts invoiced to Real Estate Company included 10% profit margin.

Construction Company

- No borrowings during the period.
- Financed ₹ 10,00,000 of expenditures on qualifying assets using its own cash resources.

Finance Company

- Raised ₹ 20,00,000 at 7% p.a. externally and issued a loan to Parent Company for general corporate purposes at the rate of 8%.

Parent Company

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

Compute the amount of borrowing costs eligible for capitalisation in the financial statements of each of the four entities for the current reporting period 20X1-20X2.

Answers

1. 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.

As per paragraph 17 of Ind AS 23, 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.

(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.

Marine Transport Limited borrows funds and incurs expenditures in the form of down payment on 1st April, 20X0. Thus, condition (a) and (b) are met. However, condition (c) is met only on 1st March, 20X2, and that too only with respect to one ship. Thus, there is no capitalisation of borrowing costs during the financial year ended 31st March, 20X1. Even during the financial year ended 31st March, 20X2, borrowing costs relating to the 'one' ship whose construction had commenced from 1st March, 20X2 will be capitalised from 1st March, 20X2 to 31st March, 20X2. All other borrowing costs are expensed.

2. The capitalisation rate is calculated as below:

Total borrowing costs / Weighted average total borrowings: 1,65,000/15,00,000 = 11%.

Interest to be capitalised is calculated as under:

— On ₹ 2,50,000 @ 11% p.a. for 9 months = ₹ 20,625

— On ₹ 3,00,000 @ 11% p.a. for 4 months = ₹ 11,000

Total interest capitalised for the year ended 31st March 20X2 is ₹ 31,625

3. Since the entity has only general borrowing hence first step will be to compute the capitalisation rate. The capitalisation rate of the general borrowings of the entity during the period of construction is calculated as follows:

Finance cost on ₹ 20 lacs 10% debentures during September – December 20X1	₹ 66,667
Interest @ 15% on overdraft of ₹ 5,00,000 in September 20X1	₹ 6,250
Interest @ 16% on overdraft of ₹ 5,00,000 in October and November 20X1	₹ 13,333
Interest @ 16% on overdraft of ₹ 7,50,000 in December 20X1	₹ 10,000
Total finance costs during September – December 20X1	₹ 96,250

Weighted average borrowings during period

$$= \frac{(20,00,000 \times 4) + (500,000 \times 3)(750,000 \times 1)}{4} = ₹\ 25,62,500$$

$$\text{Capitalisation rate} = \frac{\text{Total finance costs during the construction period}}{\text{Weighted average borrowings during the constgruction period}}$$

= 96,250 / 25,62,500 = 3.756%

4. (i) Calculation of capitalization rate on borrowings other than specific borrowings

Amount of loan (₹)	***Rate of interest***		***Amount of interest (₹)***
7,00,000	12%	=	84,000
9,00,000	11%	=	99,000
16,00,000			1,83,000
Weighted average rate of interest (1,83,000/16,00,000) x 100		=	11.4375%

(ii) Computation of borrowing cost to be capitalized for specific borrowings and general borrowings based on weighted average accumulated expenses

Date of incurrence of expenditure	*Amount spent*	*Financed through*	*Calculation*	₹
1st April, 20X1	1,50,000	Specific borrowing	1,50,000 x 9% x 10/12	11,250
1st August, 20X1	2,00,000	Specific borrowing	50,000 x 9% x 10/12	3,750
		General borrowing	1,50,000x11.4375% x 6/12	8,578.125
1st October, 20X1	3,50,000	General borrowing	3,50,000x11.4375% x 4/12	13,343.75
1st January, 20X2	1,00,000	General borrowing	1,00,000x11.4375% x 1/12	953.125
				37,875

Note: Since construction of building started on 1st April, 20X1, it is presumed that all the later expenditures on construction of building had been incurred at the beginning of the respective month.

(iii) Total expenses to be capitalized for building

	₹
Cost of building ₹ (1,50,000 + 2,00,000 + 3,50,000 + 1,00,000)	8,00,000
Add: Amount of interest to be capitalized	37,875
	8,37,875

(iv) Journal Entry

Date	*Particulars*	₹	₹
31.1.20X2	Building account Dr.	8,37,875	
	To Bank account		8,00,0000

	To Interest payable (borrowing cost) (Being expenditure incurred on construction of building and borrowing cost thereon capitalized)		37,875

Note: In the above journal entry, it is assumed that interest amount will be paid at the year end. Hence, entry for interest payable has been passed on 31.1.20X2.

Alternatively, following journal entry may be passed if interest is paid on the date of capitalization:

Date	***Particulars***	**₹**	**₹**
31.1.20X2	Building account Dr.	8,37,875	
	To Bank account		8,37,875
	(Being expenditure incurred on construction of building and borrowing cost thereon capitalized)		

5. As per Ind AS 23, when an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should 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 amount of borrowing costs eligible for capitalization, in cases where the funds are borrowed generally, should be determined based on the capitalisation rate and expenditure incurred in obtaining a qualifying asset. The costs incurred should first be allocated to the specific borrowings.

Analysis of expenditure:

Date	**Expenditure (₹ '000)**	**Amount allocated in general borrowings (₹ '000)**	**Weighted for period outstanding (₹ '000)**
1st April 20X1	200	0	0
30th June 20X1	600	100*	100 × 9/12 = 75
31st Dec 20X1	1,200	1,200	1,200 × 3/12 = 300
31st March 20X2	200	200	200 × 0/12 = 0
Total	2,200		375

*Specific borrowings of ₹ 7,00,000 fully utilized on 1st April & on 30th June to the extent of ₹ 5,00,000 hence remaining expenditure of ₹ 1,00,000 allocated to general borrowings.

The capitalisation rate relating to general borrowings should be 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.

$$\text{Capitalisation rate} = \frac{(10,00,000 \times 12.5\%) + (15,00,000 \times 10\%)}{10,00,000 + 15,00,000} = 11\%$$

Borrowing cost to be capitalized:	**Amount (₹)**
On specific loan	65,000
On General borrowing (3,75,000 × 11%)	41,250
Total	1,06,250
Less: interest income on specific borrowings	(20,000)
Amount eligible for capitalization	86,250
Therefore, the borrowing costs to be capitalized are ₹ 86,250.	

6. Following is the treatment as per Ind AS 23:

Finance Company

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

Real Estate Company

Total interest costs in the financial statements of Real Estate Company is ₹ 70,000. Expenditures on qualifying assets exceed total borrowings, so the total amount of interest can be capitalised.

Construction Company

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

Consolidated financial statements of Parent Company:

Total general borrowings of the group: ₹ 10,00,000 + ₹ 20,00,000 = ₹ 30,00,000

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

Total interest expenditures for the group = ₹ 30,00,000 x 7% = ₹ 2,10,000

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

Real Estate Company – ₹ 15,40,000/1.1 = ₹ 14,00,000

Construction Co – ₹ 10,00,000

Total consolidated expenditures on qualifying assets:₹ (14,00,000 + 10,00,000) = ₹ 24,00,000

Capitalisation rate = 7%

Borrowing costs eligible for capitalisation = ₹ 24,00,000 x 7% = ₹ 1,68,000

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 ₹ 1,68,000 can be capitalised.