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According To IAS 23, Borrowing Costs, Certain Borrowing Costs Have To Be Capitalized. Explain With Reference

In the realm of financial reporting and accounting standards, IAS 23 – Borrowing Costs – provides essential guidance on how companies should treat interest and other costs related to borrowing funds. A key aspect of this standard is the requirement that certain borrowing costs, particularly those incurred during the construction or production of qualifying assets, must be capitalized rather than expensed immediately. This article explores the detailed provisions of IAS 23 regarding borrowing costs, the criteria for capitalization, and practical references to ensure compliance and accurate financial reporting.

Understanding IAS 23: Borrowing Costs

What Are Borrowing Costs?

Borrowing costs encompass interest expense calculated using the effective interest method, ancillary costs such as loan origination fees, and other costs that an entity incurs in connection with borrowing funds. These costs are integral to the financing process and can significantly impact the financial statements of an organization.

Objectives of IAS 23

- To specify the accounting treatment for borrowing costs incurred in connection with the borrowing of funds.
- To ensure that financial statements reflect the true cost of financing assets over their useful life.
- To improve comparability and transparency in financial reporting across entities and industries.

Key Principles of IAS 23

Recognition of Borrowing Costs

IAS 23 mandates that borrowing costs directly attributable to the acquisition, construction, or production of a qualifying asset should be capitalized as part of the cost of that asset. Conversely, borrowing costs that are not directly attributable should be recognized as an expense in the period in which they are incurred.

Definition of a Qualifying Asset

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

- Construction of a new building or manufacturing plant.
- Development of intangible assets that require a lengthy development period.
- Production of large or complex inventory items.

When Should Borrowing Costs Be Capitalized?

Criteria for Capitalization

Under IAS 23, borrowing costs are capitalized when:

1. The expenditure for the asset has been incurred.
2. The borrowing costs are directly attributable to the acquisition, construction, or production of a qualifying asset.
3. The activities to prepare the asset for its intended use or sale are in progress.

Time Frame for Capitalization

Capitalization begins when:

- Expenditure on the asset has been incurred.
- Borrowing costs are being incurred.
- Activities necessary to prepare the asset for use or sale are in progress.

It ceases when the asset is substantially ready for its intended use or sale.

Practical Application and Reference Examples

Example 1: Construction of a Factory

Suppose a company is constructing a factory and borrows funds specifically for this project. The borrowing costs, including interest payments and ancillary fees, incurred during the construction period, should be capitalized as part of the cost of the factory. Once the factory is completed and ready for use, capitalization stops, and subsequent interest costs are recognized as expenses.

Example 2: Development of Software

In cases where software development involves a lengthy process, and the project qualifies as an asset, borrowing costs incurred during the development phase are capitalized. Once the software is ready for use, further borrowing costs are expensed.

Reference to IFRS Standards and Literature

- **IAS 23 (Revised 2011):** The primary source outlining the policies on borrowing costs, including detailed criteria and examples.
- **International Financial Reporting Interpretations Committee (IFRIC):** Provides interpretations and clarifications related to IAS 23.
- **IASB Exposure Drafts and Amendments:** Offer updates and revisions to standards, which should be reviewed periodically for compliance.

Accounting Treatment Based on IAS 23

Journal Entries for Capitalized Borrowing Costs

During the construction or production period, the following entries are typical:

1. **To capitalize borrowing costs:**

```
Dr. Qualifying Asset (e.g., Building, Software)          XXXX
Cr. Borrowing Costs (Interest Expense)                  XXXX
```

When the asset is ready for use, no further capitalization occurs, and subsequent interest costs are expensed:

```
Dr. Interest Expense                                    XXXX
Cr. Cash/Bank                                           XXXX
```

Exceptions and Limitations

Borrowing Costs Not to Be Capitalized

IAS 23 specifies certain costs that should not be capitalized, including:

- Borrowing costs related to assets that are not qualifying assets.
- Borrowing costs incurred during periods of idle construction or production.
- Finance costs that are capitalized as part of inventory under other standards.

Impact of Changes in Borrowing Structure

If a company refinances its debt or changes the terms of borrowing, the accounting treatment of capitalized costs may need adjustment in accordance with IAS 23 and related standards.

Conclusion

IAS 23 provides clear guidance on when and how borrowing costs should be capitalized, emphasizing the importance of correctly identifying qualifying assets and periods of capitalization. Proper compliance ensures that financial statements reflect the true costs associated with asset acquisition and development, providing stakeholders with a transparent view of an entity’s financial position. By understanding the detailed criteria, practical examples, and referencing authoritative sources like IFRS standards, companies can effectively implement IAS 23 and enhance the accuracy and consistency of their financial reporting regarding borrowing costs.

Frequently Asked Questions

What is the main requirement of IAS 23 regarding borrowing costs?

IAS 23 mandates that borrowing costs directly attributable to the acquisition, construction, or production of a qualifying asset should be capitalized as part of the asset's cost.

Which borrowing costs are required to be capitalized according to IAS 23?

Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset must be capitalized, while others should be expensed.

What is a 'qualifying asset' under IAS 23?

A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale, such as machinery, buildings, or large infrastructure projects.

How does IAS 23 specify the capitalization of borrowing costs during construction?

IAS 23 states that borrowing costs should be capitalized from the time expenditures for the asset are being incurred, and activities necessary to prepare the asset for use are in progress, until the asset is substantially ready for use or sale.

Are there any exceptions to capitalizing borrowing

costs under IAS 23?

Yes, borrowing costs on loans specifically obtained for general purposes or on funds borrowed temporarily are usually expensed, unless they are directly attributable to qualifying assets.

Can borrowing costs be capitalized if the construction of the asset is delayed?

Capitalization of borrowing costs continues only during the period when activities to prepare the asset are underway; if construction is delayed, capitalization stops until activities resume.

Additional Resources

According to IAS 23, Borrowing Costs, certain borrowing costs have to be capitalized—an accounting principle that significantly impacts financial statements, asset valuation, and corporate financial strategy. This standard, issued by the International Accounting Standards Board (IASB), provides comprehensive guidelines on the treatment of borrowing costs, emphasizing the importance of aligning accounting practices with economic realities. Understanding the nuances of IAS 23 is crucial for accountants, auditors, investors, and corporate management to ensure accurate reporting and compliance with international standards.

Introduction to IAS 23: Borrowing Costs

IAS 23, titled "Borrowing Costs," is a fundamental accounting standard that addresses the recognition, measurement, and disclosure of borrowing costs related to qualifying assets. It was issued by the IASB to promote consistency and transparency in financial reporting across entities and jurisdictions. The core premise of IAS 23 is that borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset should be capitalized as part of the cost of that asset.

This approach contrasts with the traditional method where such costs are expensed immediately in the period they are incurred. The rationale behind capitalization is that borrowing costs are part of the overall investment in the asset, and recognizing them as expenses prematurely could distort the true valuation of the asset and the entity's financial position.

Scope of IAS 23: Which Borrowing Costs Are

Covered?

IAS 23 applies to all borrowing costs that an entity incurs, but it specifically emphasizes the treatment of borrowing costs related to qualifying assets. These assets are assets that require a substantial period to bring them to their intended use or sale, such as:

- Construction projects (buildings, infrastructure)
- Manufacturing of large-scale, complex assets
- Development of intangible assets with a lengthy development period
- Purchase of assets that are under construction or development

Key points include:

- Borrowing costs include interest expense calculated using the effective interest method, finance charges in accordance with IFRS 9, and foreign exchange gains or losses on borrowings.
- Costs related to short-term borrowings, or those incurred for general corporate purposes, are generally expensed unless they are directly attributable to qualifying assets.

Exclusions:

- Borrowing costs related to inventories that are manufactured or acquired for sale in the ordinary course of business are typically expensed as incurred.
- Borrowing costs related to assets that are ready for use or sale are expensed in the period they are incurred.

Understanding Qualifying Assets

A central concept in IAS 23 is the definition of a qualifying asset. An asset qualifies if:

- It requires a substantial period to get ready for its intended use or sale.
- The period is generally considered to be more than 12 months, but this depends on the specific circumstances of the project or asset.

Characteristics of qualifying assets:

- They are not yet ready for use or sale.
- They involve extended construction, development, or production phases.
- The costs of financing these assets are directly attributable to their creation.

Implication: Only borrowing costs incurred during the period when the asset is being prepared for use or sale are eligible for capitalization. Costs incurred after the asset is ready are expensed as part of operating costs.

Accounting for Borrowing Costs: Capitalization vs. Expensing

1. Capitalization of Borrowing Costs

Under IAS 23, borrowing costs that meet the criteria are capitalized as part of the cost of a qualifying asset. The process involves:

- Determining the amount of borrowing costs eligible for capitalization.
- Recognizing these costs as part of the asset's carrying amount until the asset is ready for use or sale.

Procedural steps include:

- Calculating the amount of borrowing costs to capitalize based on the weighted average of accumulated expenditure.
- Applying the effective interest rate to the qualifying expenditures during the period.
- Adding the capitalized borrowing costs to the asset's cost basis, thus increasing its valuation.

2. Expensing Borrowing Costs

Borrowing costs that do not meet the criteria for capitalization are expensed in the period they are incurred. This includes:

- Borrowing costs on short-term borrowings used for general purposes.
- Borrowing costs on assets that are not qualifying assets.
- Borrowing costs incurred after the asset is substantially complete and ready for use or sale.

Impact: This approach ensures that expenses are recognized in the period they are incurred, aligning costs with revenues and providing a realistic picture of profitability.

Criteria for Capitalization: When to Start and Stop

1. Commencement of Capitalization

Capitalization begins when:

- Expenditure for the asset is being incurred.
- Borrowing costs are being incurred.
- Activities to prepare the asset for use or sale are in progress.

2. Suspension of Capitalization

Capitalization should be suspended during extended periods when:

- Active development or construction is interrupted.
- The entity temporarily suspends work on the asset.
- Borrowing costs are not being incurred directly to finance the asset.

3. Cessation of Capitalization

Capitalization ceases when:

- The asset is substantially complete and ready for use or sale.
- The asset is in use or available for use, even if some minor activities remain.

Additional considerations:

- Capitalization should be consistent over the project duration.
- Changes in estimates should be accounted for prospectively.

Practical Illustrations and Reference Cases

Case Study 1: Construction of a New Factory

An entity undertakes a three-year construction of a manufacturing plant. During this period:

- The company incurs interest on a long-term loan specifically taken for the project.
- Construction progresses steadily, with activities actively ongoing.
- The entity capitalizes the borrowing costs incurred during the period of construction.

Application of IAS 23:

- The interest calculated using the effective interest rate on the loan is added to the asset's cost.
- Once the factory is ready for use, capitalization stops, and subsequent borrowing costs are expensed.

Case Study 2: Development of Software for Internal Use

A tech company develops software that takes 18 months to complete. Borrowing costs related to the project are incurred during this period.

Analysis:

- Since the software development involves a substantial period before it is

ready for use, borrowing costs incurred during this phase are capitalized.
- Post-completion costs are expensed as part of operational expenses.

Real-World Reference:

Major corporations like construction firms and manufacturing entities often rely heavily on IAS 23 for their capital projects. For example, infrastructure projects such as bridges and highways involve lengthy construction phases, making borrowing cost capitalization essential for accurate asset valuation.

Disclosures and Financial Reporting Implications

IAS 23 mandates specific disclosures to provide transparency:

- The amount of borrowing costs capitalized during the period.
- The capitalization rate used.
- The capitalized amount as part of the asset's cost.
- The amount of borrowing costs recognized as expense.

Implication for stakeholders:

- Investors gain insight into the actual cost of long-term projects.
- Financial ratios such as return on assets and debt-to-equity ratios are affected by capitalization practices.
- Proper disclosure helps prevent misinterpretation of profitability and asset valuation.

Advantages and Challenges of Capitalizing Borrowing Costs

Advantages:

- Enhances the matching principle by aligning costs with associated revenues.
- Improves the valuation of long-term assets.
- Provides a more accurate picture of an entity’s financial position.

Challenges:

- Determining the precise amount of borrowing costs attributable to each qualifying asset.
- Managing complex calculations, especially when multiple borrowings are involved.
- Ensuring compliance with standards across different jurisdictions and

accounting policies.
- Potential for manipulation or inconsistent application, leading to misstatements.

Conclusion: Strategic Significance of IAS 23

IAS 23 plays a pivotal role in standardizing how entities account for borrowing costs, emphasizing the importance of capitalization for qualifying assets. By requiring that certain borrowing costs be added to the cost of assets, the standard aligns accounting practices with economic realities, providing stakeholders with a clearer understanding of an entity's investments and financial health.

However, the application of IAS 23 demands careful judgment, diligent record-keeping, and vigilant disclosure. As corporate projects become increasingly complex, and as international accounting harmonization continues, the principles embedded in IAS 23 will remain central to transparent and accurate financial reporting.

In summary, the decision to capitalize borrowing costs hinges on the nature of the asset, the duration of the project, and the direct attribution of costs. Proper adherence ensures that financial statements reflect the true cost of long-term assets, aiding investors, creditors, and management in making informed decisions—an essential aspect in today's dynamic economic environment.

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