Exposure Draft

Accounting Standard for Local Bodies (ASLB)

Borrowing Costs

(Last date for Comments: July 31*, 2008*)

Issued by
The Committee on Accounting Standards for Local Bodies
The Institute of Chartered Accountants of India

Exposure Draft
Accounting Standard for Local Bodies
Borrowing Costs

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INVITATION TO COMMENT

The Committee on Accounting Standards for Local Bodies of the Institute of Chartered Accountants of India invites comments on any aspect of this Exposure Draft of Accounting Standard for Local Bodies (ASLB), Borrowing Costs. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Comments should be submitted in writing to the Secretary, Committee on Accounting Standards for Local Bodies, The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi – 110 002, so as to be received not later than, ***July 31,*** **2008**. *Comments can also be sent by e-mail at caslb@icai.org or tdte@icai.org.*

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Borrowing Costs

(This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies[1])*

The Accounting Standard for Local Bodies (ASLB), 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the local bodies. This Standard will be mandatory for local bodies in a State from the date specified in this regard by the State Government concerned[2].

The following is the text of the Accounting Standard for Local Bodies.

[1] Attention is specifically drawn to paragraph 4.2 of the 'Preface to the Accounting Standards for Local Bodies', according to which Accounting Standards are intended to apply only to items which are material.
[2] Reference may be made to the paragraph 7.1 of the 'Preface to the Accounting Standards for Local Bodies' providing the discussion on the compliance with the Accounting Standards for Local Bodies.

Objective

This Standard prescribes the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard applies to the entities described as Local Bodies in the Preface to the Accounting Standards for Local Bodies[3].

3. This Standard does not deal with the actual or imputed cost of net assets/equity. Where a capital charge is applied to individual entities, judgement will need to be exercised whether the charge meets the definition of borrowing costs or whether it should be treated as an actual or imputed cost of net assets/equity. Charges will be treated as borrowing costs only if it meets the definition of borrowing costs.

Definitions

4. The following terms are used in this Standard with the meanings specified:

<u>Borrowing costs</u> are interest and other costs incurred by an entity in connection with the borrowing of funds.

<u>Control</u> is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

<u>Controlled entity</u> is an entity that is under the control of another entity (known as the controlling entity).

<u>Controlling entity</u> is an entity that has one or more controlled entities.

<u>Economic entity</u> means a group of entities comprising a controlling entity and one or more controlled entities.

<u>Net assets</u>/equity is the residual interest in the assets of the entity after deducting all its liabilities.

<u>Qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Borrowing Costs

[3] Refer paragraph 1.3 of the 'Preface to the Accounting Standards for Local Bodies'.

5. Borrowing costs may include:

(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;

(d) finance charges in respect of assets acquired under finance leases or under similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowing costs to be accounted for under this Standard and the remaining exchange difference, if any, will be accounted for under Accounting Standard for Local Bodies (ASLB) on *'The Effects of Changes in Foreign Exchange Rates'*[4]. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the entity would have raised the borrowings locally had the entity not decided to raise the foreign currency borrowings. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, *'The Effects of Changes in Foreign Exchange Rates'*, until the ASLB on this subject is formulated.

The application of this explanation is illustrated in the Appendix A.

Economic Entity

6. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

7. Other terms sometimes used to refer to an economic entity include "administrative entity", "financial entity", "consolidated entity" and "group".

8. An economic entity may include entities with both social policy and commercial objectives. For example, a local body may be an economic entity which includes entities

[4] The Accounting Standard for Local Bodies is under preparation.

that provide services such as health care for a nominal charge, as well as entities that provide services on a commercial basis e.g., transport services.

Net Assets/Equity

9. "Net assets/equity" is the term used in this Standard to refer to the residual measure in the balance sheet (assets less liabilities). Net assets/equity may be positive or negative. Other terms may be used in place of net assets/equity, provided that their meaning is clear.

Qualifying Assets

10. What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

11. Examples of qualifying assets are office buildings, hospitals, infrastructure assets such as roads, bridges and power generation facilities, and inventories that require a substantial period of time to bring them to a condition ready for use or sale, and investment properties. Other investments and those inventories that are routinely produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

12. Borrowing costs should be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 13.

13. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard.

14. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits or service potential to the entity and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

15. 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.

16. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when an economic entity uses a range of debt instruments to borrow funds at varying rates of interest, and transfers those funds on various bases to other entities in the economic entity. Funds which have been borrowed centrally may be transferred to other entities within the economic entity as a loan, a grant or a capital injection. Such transfers may be interest-free or require that only a portion of the actual interest cost be recovered. Other complications arise through the use of loans denominated in or linked to foreign currencies and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is difficult and the exercise of judgment is required.

17. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

18. The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring 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 expenditures on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on temporary investment of such funds is deducted from the borrowing costs incurred.

19. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate should be 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. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

The calculation of weighted average rate of borrowings is illustrated in Appendix B.

20. Only those borrowing costs applicable to the borrowings of the entity may be capitalised. When a controlling entity borrows funds which are passed on to a controlled

entity with no, or only partial allocation of borrowing costs, the controlled entity may capitalise only those borrowing costs which it itself has incurred. Where a controlled entity receives an interest-free capital contribution or capital grant, it will not incur any borrowing costs and consequently will not capitalise any such costs.

21. When a controlling entity transfers funds at partial cost to a controlled entity, the controlled entity may capitalise that portion of borrowing costs which it itself has incurred. In the financial statements of the economic entity, the full amount of borrowing costs can be capitalised to the qualifying asset, provided that appropriate consolidation adjustments have been made to eliminate those costs capitalised by the controlled entity.

22. When a controlling entity has transferred funds at no cost to a controlled entity, neither the controlling entity nor the controlled entity would meet the criteria for capitalisation of borrowing costs. However, if the economic entity met the criteria for capitalisation of borrowing costs, it would be able to capitalise the borrowing costs to the qualifying asset in its financial statements.

23. In some circumstances, it is appropriate to include all borrowings of the controlling entity and its controlled entities when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each controlled entity to use a weighted average of the borrowing costs applicable to its own borrowings.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

24. 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 Accounting Standards for Local Bodies. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those Accounting Standards.

Commencement of Capitalisation

25. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

> ***(a) expenditure for the acquisition, construction or production of qualifying asset is being incurred;***
>
> ***(b) borrowing costs are being incurred; and***
>
> ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.***

26. Expenditures on a qualifying asset include only such expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities. The expenditure is reduced by any progress payments received and grants received in connection with the asset. 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.

27. 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.

Suspension of Capitalisation

28. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. Such borrowing costs are expensed.

29. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also 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 needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

30. 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.

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

32. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.

33. Example of a qualifying asset for which each part is capable of being used while construction continues for the other parts is an office development comprising several buildings, each of which can be used individually.

34. Examples of qualifying assets that need to be completed before any part can be used include an operating theatre in a hospital when all construction must be complete before the theatre may be used; a sewage treatment plant where several processes are carried out in sequence at different parts of the plant; and a bridge forming part of a highway. In such cases, capitalisation of borrowing costs should be continued.

Disclosure

35. The financial statements should disclose:

> ***(a) the accounting policy adopted for borrowing costs;***
>
> ***(b) the amount of borrowing costs capitalised during the period; and***
>
> ***(c) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation (when it was necessary to apply a capitalisation rate to funds borrowed generally).***

Transitional Provisions

36. An entity shall apply this standard prospectively.

Appendix A

Illustration 1

Note: This appendix is illustrative only and does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the paragraph 4 (e) of the standard.

Facts:

Local Body XYZ has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by Local Body XYZ in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of this Accounting Standard for Local Bodies:

(i) Interest for the period = USD 10,000 x 5%x Rs. 48/USD = Rs. 24,000/-

(ii) Increase in the liability towards the principal amount =USD10,000 x (48-45) = Rs. 30,000/-

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11% = Rs. 49,500

(iii) Difference between interest on local currency borrowing and foreign currency borrowing =Rs. 49,500 – Rs. 24,000 =Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of this *Accounting Standard for Local Bodies*) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per this *Accounting Standard for Local Bodies* and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard for Local Bodies (ASLB) on '*The Effects of Changes in Foreign Exchange Rates'*[5]. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, '*The Effects of Changes in Foreign Exchange Rates*', until the ASLB on this subject is formulated.

[5] The Accounting Standard for Local Bodies is under preparation.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., Rs. 34,500 (Rs. 58,500 – Rs. 24,000)) is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under this Accounting Standard for Local Bodies and there would be no exchange difference to be accounted for under proposed ASLB on '*The Effects of Changes in Foreign Exchange Rates*'.

Appendix B

Illustration 2

Note: This appendix is illustrative only and does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the paragraph 19 of the standard.

Facts:

Local Body XYZ has the following loans with the different rates of interest during the year 20X7-X8:

Rs. 10,00,000 @ 8%

Rs. 15,00,000 @ 9%

Rs. 18,00,000 @ 10%

Local Body XYZ incurs certain expenditure in constructing an asset meeting the definition of qualifying asset from the above borrowed amounts. Local Body XYZ has not taken the above loans specifically for the purpose of qualifying asset for which borrowing cost is to be capitalized and included in its cost.

The capitalization rate for determining the amount of borrowing cost eligible for capitalization will be the weighted-average interest rate, which may be computed as follows:

Rs. 10,00,000 x 8%	=	Rs. 80,000
Rs. 15,00,000 x 9%	=	Rs. 1,35,000
Rs. 18,00,000 x 10%	=	Rs. 1,80,000
		Rs. 3,95,000

Weighted-average interest rate = Rs. 3,95,000/ Rs. 43,00,000 = 9.19%

Borrowing cost at a 9.19% interest rate will be applied to the expenditure incurred on the qualifying asset for determining the borrowing costs eligible for capitalization. If out of the above three loans, one is taken specifically for the purpose of obtaining the qualifying asset, borrowing cost will be determined using the interest rate applicable to that loan for the expenditure incurred to the amount of the loan. Borrowing costs for any remaining amount of expenditure will be calculated for capitalisation at the weighted-average interest rate for the remaining two loans.

Appendix C

Note: This Appendix is not a part of the Accounting Standard for Local bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) and the corresponding International Public Sector Accounting Standard (IPSAS) 5, Borrowing Costs issued by International Public Sector Accounting Standards Board.

COMPARISON WITH IPSAS 5, *BORROWING COSTS*

1. Capitalisation of Borrowing Costs

IPSAS 5 prescribes the expensing of the borrowing costs as 'benchmark treatment'. However in relation to the borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, it provides an option of capitalising such borrowing costs in the cost of that asset.

As compared to above, the Exposure draft of ASLB does not provide the option as IPSAS 5. It requires that the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset only.

2. Substantial Period of Time

IPSAS 5 does not provide the meaning of the expression 'substantial period of time'. It provides only examples of the qualifying Asset requiring the substantial period of time.

Exposure Draft of ASLB provides the interpretation of the expression 'substantial period of time'. It provides that ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case.

3. Commitment Charges

Exposure Draft ASLB provides that the Borrowing Costs may include commitment charges on bank borrowings. However, IPSAS 5 does not provide for including the commitment charges on bank borrowings.