

Borrowing costs (Lecture A644 – 4.38 minutes)

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* deals with borrowing costs in Section 25 *Borrowing Costs*. The term ‘borrowing costs’ is defined in the Glossary as:

‘Interest and other costs incurred by an entity in connection with the borrowing of funds.’

FRS 102 Glossary
borrowing costs

Recognition

Section 25 of FRS 102 allows an accounting policy choice where borrowing costs are concerned – they can either be capitalised as part of the cost of a qualifying asset or they are expensed as incurred. The term ‘qualifying asset’ is defined as:

*‘An **asset** that necessarily takes a substantial period of time to get ready for its intended use or sale. Depending on the circumstances any of the following may be qualifying assets:*

FRS 102 Glossary
qualifying asset

- (a) **inventories**;*
- (b) **manufacturing plants**;*
- (c) **power generation facilities**;*
- (d) **intangible assets**; and*
- (e) **investment properties**.*

***Financial assets**, and inventories that are 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.’*

The definition of a qualifying asset refers to an asset which ‘... takes a substantial period of time to get ready for its intended use or sale.’ The term ‘substantial period of time’ is not a defined term in FRS 102 and will involve the exercise of judgement, but in practice it would not be a period shorter than 12 months. It would be unusual for an entity to capitalise borrowing costs where the period of construction is less than 12 months because of the work involved and the overall immaterial effect this may have on the financial statements.

It is important to emphasise that where the entity is a micro-entity that has chosen to apply FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* as its financial reporting framework, there is no accounting policy choice available. Borrowing costs must be written off to profit and loss as incurred – they must not be capitalised.

Companies applying FRS 102 which choose to capitalise borrowing costs must do so consistently for a class of qualifying assets. It follows, therefore, that if an entity decides to change its accounting policy from expensing to capitalising or vice versa, this will represent a change in accounting policy. Voluntary changes in accounting policy are permissible under FRS 102 at Section 10 *Accounting Policies, Estimates and Errors*. However, paragraph 10.8 says that a change in accounting policy should only be effected if that change:

'(a) is required by an FRS; or

FRS 102, para 10.8

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.'

It would not be considered appropriate (or cost-effective) if an entity were to change between capitalising and expensing from one period to the next and this would also bring into question the overall intention of management and what it is they are trying to achieve by consistently changing their policy in the area of borrowing costs (for example manipulation of the financial statements to achieve a desired outcome).

If an entity changes an accounting policy because the change will result in the financial statements providing reliable and more relevant information, the change is applied retrospectively.

Specific borrowings used in constructing an asset

Paragraph 25.2A of FRS 102 says that borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset are those costs which the entity would have avoided if the expenditure on the qualifying asset had not been made. In practice, where an entity is self-constructing an asset it is common to take out specific finance to undertake the project if the business has not got access to the finance in the form of disposable income. Where specific borrowing costs are incurred on a project, management must determine the amount of borrowing costs which are eligible for capitalisation. This will be the actual borrowing costs incurred less any investment income (ie bank interest) received on the temporary investment of those borrowings.

Investment income would arise if the entity were to deposit undrawn funds in an interest-bearing bank account, such as a deposit account.

General borrowings used in constructing an asset

It may be the case that an entity which is constructing a qualifying asset will use general borrowings to fund the project rather than incur specific borrowings. Paragraph 25.2C of FRS 102 says that to the extent that funds applied to obtain a qualifying asset form part of the entity's general borrowings, the amount of borrowing costs eligible for capitalisation are determined by applying a capitalisation rate to the expenditure on that asset.

Clearly, when an entity uses general borrowings to fund a qualifying asset, the amount of the borrowing costs which are eligible for capitalisation is not as clear-cut as it would be had specific borrowings been incurred. The use of general borrowings where an entity has a policy of capitalisation of borrowing costs will create inherent complexities in determining the amounts eligible for capitalisation.

Capitalisation rate

The capitalisation rate used during an accounting period is the weighted average of rates applicable to the entity's general borrowings which are outstanding during the period. The amount of borrowing costs which an entity capitalises during the reporting period cannot exceed the amount of borrowing costs incurred during that same period.

Example – Calculation and use of a capitalisation rate

During the year to 31 October 2018, Pastures Ltd commenced a property development, incurring the following expenses:

	£
July 2018	16,000
August 2018	20,000
September 2018	25,000

The company has a range of borrowings on which interest has been paid as follows:

	Balance outstanding	Interest paid
	£	£
7-year loan at 9%	18,000	1,620
8-year loan at 8%	32,000	2,560
1-year loan	11,000	1,000
Bank overdraft (average)	<u>9,000</u>	<u>950</u>
	70,000	6,130

The capitalisation rate to be applied on the qualifying expenditure is calculated as:

$$£6,130 / £70,000 \times 100 = 8.76\%$$

The interest capitalised during the year is as follows:

	£
£16,000 x 5/12 x 8.76%	584
£20,000 x 3/12 x 8.76%	438
£25,000 x 2/12 x 8.76%	<u>365</u>
Interest to capitalise	<u>1,387</u>

The total interest paid in the year is £6,130 and the borrowing costs eligible for capitalisation are £1,387 and so the rule in FRS 102, para 25.2C which prohibits the amount of capitalised interest exceeding the amount of borrowing costs incurred during the period is not breached. If the amount eligible for capitalisation were higher than the amount of borrowing costs incurred, the amount capitalised in the period would be capped at the total amount of borrowing costs incurred in the period.

The rule in paragraph 25.2C which restricts the amount of borrowing costs capitalised if they exceed the amount of borrowing costs incurred may not pose a problem in an individual entity's financial

statements. Problems may, however, arise in a group context where individual subsidiaries correctly capitalise borrowing costs, but at group level the total amount of borrowing costs capitalised may exceed the borrowing costs incurred for the group as a whole. This will necessitate a consolidation adjustment to reduce the amount of borrowing costs capitalised at group level.

Period of capitalisation

The period of capitalisation is outlined in paragraphs 25.2D(a) to (c) of FRS 102.

Paragraph 25.2D of FRS 102 requires an entity that chooses to capitalise borrowing costs to:

- capitalise borrowing costs from the point it first incurs expenditure on the qualifying asset and undertakes activities to prepare the asset for its intended use or sale;
- suspend capitalisation during periods where active development is paused; and
- cease capitalisation when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Example – Construction is suspended

Winter Enterprises Ltd is constructing a new building for use in its operations. It has taken out a bank loan to fund the project and incurs interest on a monthly basis. The company has adopted a policy of capitalising the interest incurred on the borrowings as part of the cost of the building.

In April, construction was stopped because of an accident on the site. The period of suspension was four months and during that time the finance director has continued to post the interest incurred on the borrowings to the cost of the new building.

The finance director is incorrect to continue capitalising the borrowing costs during the period of suspension. Paragraph 25.2D(b) is specific that capitalisation must be suspended during extended periods where active development of the asset has paused.

Paragraph 25.2D(b) refers to 'extended periods' but this is not a defined term. Professional judgement will therefore be needed when determining whether any pause in the construction is an extended period and hence suspend capitalisation.

Capitalisation must cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Cessation of capitalisation is necessary because the asset will effectively be ready for use or sale regardless of the fact that additional administrative procedures may still need to be completed. However, where there are unavoidable issues which prevent the asset from being used as intended or sold, continued capitalisation of borrowing costs may be appropriate as illustrated in the following example.

Example – Legislative clearance required

On 10 June 2018, Galway Ltd completed the building of a new warehouse which it had funded by specific borrowings through a four-year bank loan. The company has a policy of capitalising the interest on this loan as part of the cost of the new warehouse.

The company has to have clearance from the Health and Safety directorate before it can be used due to the nature of the products being stored in the warehouse. This clearance cannot be obtained until September 2018 due to a backlog of cases being handled by the Health and Safety directorate. The finance director is unsure whether to continue capitalising the borrowing costs which the company will incur in the months of June 2018 to September 2018.

Ordinarily, capitalisation will cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete. However, when it is not possible to avoid a delay between physical completion and any consents required to use the asset, capitalisation of borrowing costs will continue to be appropriate. This is because until the Health and Safety clearance is received, the asset cannot be regarded as ready for intended use.

In the example above, the delay between the physical completion of the asset and the point at which it is ready for intended use was due to formalities beyond the control of the company. Continued capitalisation was therefore appropriate between the date of physical completion and clearance being received. However, if the delay in physical completion is intentional rather than unavoidable, capitalisation of borrowing costs must cease.

Disclosure requirements

When an entity reporting under FRS 102 does not adopt a policy of capitalising borrowing costs, there are no additional disclosure requirements prescribed by Section 25 of FRS 102.

Interest payable and similar expenses will be shown as a separate line item in a Format 1 profit and loss account and paragraph 11.48(b) of FRS 102 requires an entity to disclose total interest expense calculated using the effective interest method for financial liabilities which are not at fair value through profit or loss.

If an entity adopts a policy of capitalising borrowing costs, it must disclose:

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

*FRS 102, para
25.3A(a) and (b)*

(b) the capitalisation rate used.’

Disclosures in respect of capitalised borrowing costs are also needed under the Accounting Regulations (Schedule 1 paragraph 27(3)). These require the amount of interest included in the cost of an asset to be disclosed in a note to the accounts. This is different than the requirements of FRS 102 which require disclosure of the amount of borrowing costs capitalised in the period; the Companies Act 2006 requires the cumulative amount of interest included in the cost of the asset to be disclosed.