Accounting Standard

AASB 1036
December 1997

Borrowing Costs

Issued by the
Australian Accounting Standards Board

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MAIN FEATURES OF THE STANDARD

The Standard:

(a) requires borrowing costs to be recognised as an expense in the financial year in which they are incurred, except to the extent they are capitalised

(b) requires the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset

(c) prescribes when the capitalisation of borrowing costs in respect of qualifying assets ceases or is suspended

(d) prescribes the methods to be used to allocate borrowing costs to individual qualifying assets

(e) requires specified disclosures in relation to borrowing costs

(f) defines "borrowing costs" and "qualifying asset".

ACCOUNTING STANDARD AASB 1036

The Australian Accounting Standards Board makes Accounting Standard AASB 1036 "Borrowing Costs" under section 32 of the *Corporations Act 1989*.

Dated 15 December 1997

K H Spencer
Director – AASB

ACCOUNTING STANDARD

AASB 1036 "BORROWING COSTS"

1 Application

1.1 This Standard applies to each *entity* which is required to prepare financial statements in accordance with Part 3.6 of the Corporations Law and which:

(a) is a *reporting entity*; or

(b) holds those financial statements out to be, or form part of, a *general purpose financial report*.

1.2 In relation to the treatment of *borrowing costs*, this Standard overrides the requirements of Accounting Standard AASB 1022 "Accounting for the Extractive Industries".

1.2.1 The standards specified in this Standard apply to the *financial report* where information resulting from their application is material, in accordance with Accounting Standard AASB 1031 "Materiality".

2 Operative Date

2.1 This Standard applies to *financial years* ending on or after 31 December 1998. This Standard may be applied to financial years ending before 31 December 1998 where an election has been made in accordance with subsection 285(3) of the Corporations Law.

2.2.1 Notice of this Standard was published in *the Commonwealth of Australia Gazette* on 16 December 1997.

3 Purpose of Standard

3.1 The purpose of this Standard is to:

(a) prescribe the accounting treatment of *borrowing costs*, including when such costs must be capitalised as part of the *carrying amount* of *qualifying assets*

(b) prescribe the methods to be used to allocate borrowing costs to individual qualifying assets

(c) require certain disclosures to be made about borrowing costs.

4 Recognition of Borrowing Costs

4.1 *Borrowing costs* must be *recognised* as an *expense* in the *financial year* in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 4.2.

4.2 Borrowing costs that are directly attributable to the acquisition, construction or production of a *qualifying asset* must be capitalised as part of the cost of that *asset* in accordance with paragraphs 5.1 to 5.3. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset must be determined as those borrowing costs which would have been avoided if the expenditure on the qualifying asset had not been made.

4.2.1 *Entities* incur a variety of costs in the process of acquiring, constructing or producing assets, including interest and similar borrowing costs. When it is probable that the incurrence of borrowing costs will result in future economic benefits and they can be reliably measured, they are included in the *carrying amount* of those assets, subject to the assets in question meeting the definition of qualifying assets (refer to paragraphs 11.1.8 to 11.1.13).

4.2.2 Borrowing costs are also incurred for purposes other than to acquire the future economic benefits embodied in qualifying assets, in which case they are treated as part of the periodic expenses of financing the entity's operations. This would include borrowing costs relating to working capital and the holding of equity securities.

5 Borrowing Costs to be Capitalised

5.1 The amount of *borrowing costs* capitalised during a *financial year* must not exceed the amount of borrowing costs incurred during that financial year by the *entity*.

Funds Borrowed Generally

5.2 To the extent that funds are borrowed generally, the amount of borrowing costs to be capitalised to *qualifying assets* must be determined by applying a capitalisation rate to the weighted average accumulated expenditures relating to qualifying assets during the financial year. Such expenditures must give rise to borrowing costs that could have been avoided and must be incurred in making qualifying assets ready for their intended use or sale. These expenditures must be reduced by any borrowings dealt with under paragraph 5.3, expenditures recovered through progress payments received and specific purpose or restricted grants received. The capitalisation rate must be the weighted average rate applicable to the borrowings of the entity that are outstanding during the financial year, other than borrowing costs dealt with under paragraph 5.3.

5.2.1 Borrowings may be made through a central treasury function within an entity when it is opportune to do so. In such cases it may be difficult to identify a direct relationship between funding and the acquisition, construction and production of particular qualifying assets. Nevertheless, borrowing costs that could have been avoided will have been incurred. In these circumstances, it is appropriate to apply a general rate, that is, the weighted average cost of borrowings for the financial year, to the average amount of accumulated expenditures on qualifying assets during the financial year.

5.2.2 There may be situations in which the treatment of borrowing costs differs between entities within an *economic entity*. For example, a *parent entity* may borrow funds which are then lent to a *subsidiary* to construct a qualifying asset. In the parent entity's *financial report* the borrowing costs would be *recognised* as *expenses*. However, in the subsidiary's and economic entity's financial reports, they would be capitalised to the qualifying asset. Another example is where a parent entity borrows funds which are then passed on to a subsidiary as *equity* or as a grant to construct a qualifying asset. In the parent entity's and subsidiary's financial reports the borrowing costs would be recognised as expenses. However, in the economic entity's financial report they would be capitalised to the qualifying asset.

5.2.3 The capitalisation rate is applied to expenditures relating to qualifying assets that give rise to borrowing costs that could have been avoided. Such expenditures are those that have resulted in payments of cash, exchanges of non-monetary or other *assets* or the assumption of interest-bearing *liabilities*. The capitalisation rate is not applied to any amount of qualifying assets that relates to expenditures recognised as liabilities that do not bear interest as such expenditures do not give rise to borrowing costs.

5.2.4 Expenditures on qualifying assets to which the capitalisation rate is applied are reduced by any progress payments received and specific purpose or restricted grants received in connection with the asset. The expenditures financed by specific purpose or restricted grants are excluded because they reduce the need to borrow. This exclusion is irrespective of the treatment of such grants as *revenue* in the financial report. When determining the amount of progress payments received to be deducted from the expenditures on a qualifying asset only the cost elements of progress payments are deducted.

Funds Borrowed Specifically for a Qualifying Asset

5.3 To the extent that funds are borrowed specifically for acquiring, constructing or producing a qualifying asset, the actual borrowing costs incurred on that borrowing during the financial year must be capitalised to that asset, to the extent that the borrowing is expected to be used for the qualifying asset. In determining the amount of borrowing costs to be capitalised during a financial year, investment revenue earned on such funds must be deducted from the borrowing costs incurred.

5.3.1 When an entity borrows funds specifically for acquiring, constructing or producing a qualifying asset, the borrowing costs that directly relate to that qualifying asset are likely to be identifiable. However, great care should be exercised in coming to such a judgement because it implies that when cash resources, as opposed to borrowings, are applied to a qualifying asset they are free of a cost of debt. This would not be so when those resources had come from borrowings or would subsequently be replaced by later borrowings. Indeed, it may only be in very simple or start-up operations, or in relation to particular projects, that a direct link can and should be drawn between the source and specific application of borrowed funds. In the majority of cases, the relationship between borrowings and qualifying assets will be much more general and paragraph 5.2 will apply.

5.3.2 When an entity borrows specifically for a qualifying asset, and as part of the transaction borrows more than it is expected will be used to acquire, construct or produce the asset, the borrowing costs to be capitalised would be only those relating to the amount expected to be used in acquiring, constructing or producing the asset.

5.3.3 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 expended on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. Investment revenue earned on such funds is deducted from the borrowing costs incurred in determining the amount to be capitalised.

6 Recoverable Amount

6.1 Subject to paragraph 6.2, when the *carrying amount* of a *qualifying asset* exceeds its *recoverable amount,* the carrying amount must be written down to that recoverable amount.

6.2 The standard in paragraph 6.1 does not apply where, pursuant to legislation, ministerial directive or other government authority, a qualifying asset is a *non-current asset* that provides goods or services at no charge, or at less than full cost recovery.

6.2.1 Accounting Standard AASB 1010 “Accounting for the Revaluation of Non-Current Assets” deals with the application of the recoverable amount constraint.

7 Commencement, Suspension and Cessation of Capitalisation

Commencement of Capitalisation

7.1 The capitalisation of *borrowing costs* as part of the cost of a *qualifying asset* must commence when:

(a) costs for the *asset* are being incurred; and

(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.

7.1.1 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, an entity would commence the capitalisation of borrowing costs to land under development during the *financial year* in which activities related to the development are undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity having commenced do not qualify for capitalisation.

Suspension of Capitalisation

7.2 Borrowing costs incurred while active development is interrupted for an extended period must be *recognised* as *expenses.*

7.2.1 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. For example, construction may be temporarily suspended until market conditions improve or due to a prolonged labour dispute. The events causing the suspension may or may not be directly related to the qualifying asset. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not 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 certain types of inventories to mature or the extended period during which high water levels delay construction of an infrastructure asset, if such high water levels are common during the construction period in the region involved.

Cessation of Capitalisation

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

7.3.1 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.

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

7.4.1 A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used or sold while construction continues on other parts. An example of a qualifying asset that needs to be completed before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

8 Disclosures

8.1 The following information must be disclosed:

(a) the amount of *borrowing costs recognised* as an *expense* for the *financial year* in accordance with paragraph 4.1

(b) **the amount of borrowing costs recognised during the financial year as part of the *carrying amount* of *qualifying assets* in accordance with paragraph 4.2**

(c) **the capitalisation rate used to determine the amount of borrowing costs in accordance with paragraph 5.2**

(d) **the amount of any investment *revenue* earned on borrowed funds that has been deducted from the borrowing costs incurred, determined in accordance with paragraph 5.3.**

8.1.1 Where borrowing costs are capitalised in relation to funds that are borrowed both generally and specifically, the capitalisation rate to disclose under paragraph 8.1(c) would be a weighted average rate relating only to the general borrowings.

8.1.2 Accounting Standard AASB 1001 "Accounting Policies" sets down the criteria for selecting and applying accounting policies. It also requires disclosures in relation to policies adopted.

9 Comparative Information

9.1 **Information for the preceding corresponding *financial year* which corresponds to the disclosures specified for the current financial year must be disclosed, except in respect of the financial year to which this Standard is first applied.**

10 Transitional Provisions

10.1 **Where the accounting policies required by this Standard are not already being applied as at the beginning of the *financial year* to which this Standard is first applied, they must be applied to all *borrowing costs* incurred after that date.**

10.1.1 The transitional provisions require that the accounting policies in this Standard be applied prospectively. Entities that have been applying different accounting policies, for example, *recognising* all borrowing costs as *expenses* when incurred, would not adjust the opening balances of their financial statements when this Standard is first applied.

11 Definitions

11.1 In this Standard:

***accounts* is defined in the Corporations Law**

***assets* means future economic benefits controlled by the *entity* as a result of past transactions or other past events**

***borrowing corporation* is defined in the Corporations Law**

***borrowing costs* means interest and other costs incurred by an entity in connection with the borrowing of funds**

***carrying amount* means the amount at which an *asset* is *recognised* in the balance sheet as at the reporting date, net of any provisions for depreciation, amortisation or diminution in value**

***company* is defined in the Corporations Law**

***consolidated accounts* is defined in the Corporations Law**

***current assets* means cash or other assets of the entity that would in the ordinary course of operations of the entity be consumed or converted into cash within twelve months after the end of the last *financial year* of the entity**

economic entity* means a group of entities comprising the *parent entity* and each of its *subsidiaries

***entity* means any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives**

equity* means the residual interest in the assets of the entity after deduction of its *liabilities

***expenses* means consumptions or losses of future economic benefits in the form of reductions in assets or increases in liabilities of the entity, other than those relating to distributions to owners, that result in a decrease in *equity* during the financial year**

financial report **means** ***accounts*** **or** ***consolidated accounts*** **or both**

financial year **is defined in the Corporations Law**

general purpose financial report **means a** ***financial report*** **intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs**

holding company **is defined in the Corporations Law**

liabilities **means future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events**

listed corporation **is defined in the Corporations Law**

non-current asset **means all assets other than** ***current asse*****ts**

parent entity **means an entity which controls another entity**

profit and loss account **is defined in the Corporations Law**

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

recognised **means reported on, or incorporated in amounts reported on, the face of the** ***profit and loss account*** **or of the balance sheet (whether or not further disclosure of the item is made in notes)**

recoverable amount **means, in relation to an asset, the net amount that is expected to be recovered through the cash inflows and outflows arising from its continued use and subsequent disposal**

reporting date **means the end of the financial year to which the financial report relates**

reporting entity **means an entity (including an** ***economic entity*****) in respect of which it is reasonable to expect the existence of users dependent on** ***general purpose financial reports*** **for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources, and includes but is not limited to the following:**

(a) **a *listed corporation***

(b) **a *borrowing corporation***

(c) **a *company* which is not a subsidiary of a *holding company* incorporated in Australia and which is a subsidiary of a foreign company where that foreign company has its securities listed for quotation on a *stock market* or those securities are traded on a stock market**

***revenues* means inflows or other enhancements, or savings in outflows, of future economic benefits in the form of increases in assets or reductions in liabilities of the entity, other than those relating to contributions by owners, that result in an increase in equity during the financial year**

***stock market* is defined in the Corporations Law**

***subsidiary* means an entity which is controlled by a parent entity.**

Assets, Liabilities, Equity, Revenues and Expenses

11.1.1 Guidance as to the definitions of assets, liabilities, equity, *revenues* and *expenses* is contained in Statement of Accounting Concepts SAC 4 "Definition and Recognition of the Elements of Financial Statements".

Borrowing Costs

11.1.2 *Borrowing costs* include:

(a) interest on bank overdrafts and 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 finance leases recognised in accordance with Accounting Standard AASB 1008 "Accounting for Leases"

(e) exchange differences arising from foreign currency borrowings net of the effects of any hedge of the borrowings.

11.1.3 When borrowings have been discounted to determine their carrying amounts, the subsequent increases in those amounts resulting from the expiry of time are in the nature of interest and would be included in paragraph 11.1.2(a).

11.1.4 The (implicit) interest addressed in paragraph 11.1.3 is distinguished from imputed interest on equity which is not recognised in general purpose financial reports.

11.1.5 When financial instruments are classified as liabilities, as opposed to equity, the outgoings relating to those instruments need to be classified as borrowing costs. This is irrespective of legal form. For example, what may be termed "dividends" on redeemable preference shares are in the nature of borrowing costs and would be included in paragraph 11.1.2(a).

11.1.6 Ancillary costs mentioned in paragraph 11.1.2(c) include non-refundable costs associated with originating or acquiring a loan. Such costs are typically accrued and amortised over the period of a loan.

11.1.7 Exchange differences in relation to a foreign currency borrowing and the associated explicit interest costs would be included in paragraph 11.1.2(e). The amount of those exchange differences will be treated as if it were interest for the purposes of determining the capitalisation rates required to be used and disclosed by this Standard.

Qualifying Assets

11.1.8 Examples of *qualifying assets* are inventories that require a substantial period of time to bring them to a saleable condition, assets resulting from development and construction activities in the extractive industries, manufacturing plants, power generation facilities and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis 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.

11.1.9 Financial assets are not qualifying assets, even where they are equity securities in another entity that has a qualifying asset.

11.1.10 A substantial period of time referred to in the definition of qualifying asset is generally regarded as more than 12 months from the time activities that are necessary to prepare the asset for its intended use or sale are in progress to the time when substantially all such activities are complete.

11.1.11 Whilst a case can be made for capitalisation of borrowing costs in relation to normal inventories, the definition of qualifying assets precludes this from occurring. Furthermore, a requirement to include borrowing costs in the carrying amount for inventories which turn over on a number of occasions during a financial year is of questionable relevance to users of financial reports, given that it would lead only to a reclassification between the cost of inventories sold and borrowing costs.

Exploration and evaluation in the extractive industries

11.1.12 Accounting Standard AASB 1022 "Accounting for the Extractive Industries" allows costs of exploration and evaluation in areas of interest, where the rights to tenure are current, to be carried forward provided such costs are:

(a) expected to be recouped through successful development and exploitation of the area of interest, or alternatively by its sale; or

(b) exploration and evaluation activities in the area of interest that have not at *reporting date* reached a stage which permits a reasonable assessment of the existence or otherwise of economically recoverable reserves, and active and significant operations in, or in relation to, the area of interest are continuing.

11.1.13 As with all assets, qualifying assets are only recognised when it is probable that the future economic benefits embodied in the asset will eventuate and the asset possesses a cost or other value that can be measured reliably. The probability criterion would generally be met in relation to exploration and evaluation costs where they are accumulated on the basis that they are expected to be recouped through successful development and exploitation, or alternatively by sale [paragraph 11.1.12(a)]. The probability criterion would not be met in relation to exploration and evaluation costs where they are accumulated on the basis that activities have not reached a stage which permits a reasonable assessment of the existence or otherwise of economically recoverable reserves [paragraph 11.1.12(b)]. For this reason, where costs relating to areas of interest from exploration and evaluation activities in the extractive industries are accumulated on the basis described in paragraph 11.1.12(a), they are eligible to be considered as qualifying assets for the purposes of this Standard. However, where costs relating to areas of interest are accumulated on the basis described in paragraph 11.1.12(b), they are not qualifying assets for the purposes of this Standard. In this latter case, any borrowing costs would be recognised as an expense in the financial year in which they are incurred, under paragraph 4.1. In either case, the costs accumulated to areas of interest from exploration and evaluation activities may include the depreciation of assets, such as portable drilling equipment, that were qualifying assets during their acquisition, construction or production.

CONFORMITY WITH INTERNATIONAL AND NEW ZEALAND ACCOUNTING STANDARDS

Conformity with International Accounting Standards

As at the date of issue of this Standard, compliance with this Standard will ensure conformity with International Accounting Standard IAS 23 "Borrowing Costs".

Conformity with New Zealand Accounting Standards

New Zealand has no accounting standard on this topic.

Financial Reporting Standard FRS-4 "Accounting for Inventories" includes commentary that is consistent with this Standard in relation to inventories. The treatment of borrowing costs is also being reviewed by the Financial Reporting Standards Board in the context of a proposed Exposure Draft titled "Accounting for Property, Plant and Equipment".

DEVELOPMENT OF THE STANDARD

This section does not form part of the Standard. It is a summary of the development of the Standard.

1 The issue of the Standard is part of a program being undertaken by the Public Sector Accounting Standards Board (PSASB) of the Australian Accounting Research Foundation (AARF) and the Australian Accounting Standards Board (AASB) to achieve greater harmony between Australian accounting standards and those of the International Accounting Standards Committee (IASC).

2 The issue of the Standard follows consideration of the responses received on Exposure Draft ED 75 "Borrowing Costs", which was prepared by the PSASB and the AASB and released in March 1997.

Principal Features of ED 75 Retained in the Standard

3 The Standard retains the basic structure and content of ED 75. Borrowing costs are required to be capitalised where they are directly attributable to the acquisition, construction or production of a qualifying asset. In all other circumstances borrowing costs are required to be recognised as an expense.

4 In relation to borrowing costs, the Boards are of the view that in an historical cost, modified historical cost or, indeed, any other input cost accounting system, costs which are incurred in obtaining control over the future economic benefits which constitute assets should generally form part of the carrying amount of those assets (providing such costs are recoverable). The Boards see no difference between freight, insurance, installation, borrowing and other input costs in this regard.

5 It is required that investment revenue on the temporary investment of specifically borrowed funds be offset against the cost of those funds to be capitalised. This is the approach adopted in IAS 23. However, in the United States (refer Statement of Financial Accounting Standards No. 62 "Capitalisation of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants") this approach is prohibited except in situations involving the acquisition of qualifying assets financed with the proceeds of tax-exempt borrowings if those funds are externally restricted. The view of the Financial Accounting Standards Board (FASB) in the United States is that the earning of interest revenue arises outside of the acquisition and as a consequence of a separate

financing transaction. The Boards considered the FASB view, but decided to harmonise with the IASC position. They do not expect the issue to arise often or to be significant on most occasions.

6 The definition of borrowing costs includes exchange differences arising from foreign currency borrowings. Those exchange differences will be treated as if they were interest for the purposes of determining the capitalisation rates required to be used and disclosed by this Standard. This is consistent with the IAS 23 treatment. However, in the United States (refer Statement of Financial Accounting Standards No. 52 "Foreign Currency Translation") such exchange differences must be recognised immediately as revenue or expenses. The Boards have given primacy to the objective of harmonising Australian and IASC standards.