# STAFF PAPER
# Application of the *Process for Modifying IFRSs for PBE/NFP* to Borrowing Costs

## PURPOSE

1 The purpose of this staff paper is to assist the Board in forming its view, through assessment against the *Process for Modifying IFRSs for PBE/NFP* ('the *Process*')[1], as to whether the accounting for borrowing costs of not-for-profit (NFP) public sector entities should continue to be modified from that specified by IAS 23 *Borrowing Costs*.

## BACKGROUND

2 AASB 123 *Borrowing Costs* (which incorporates IAS 23, issued by the IASB in March 2007) requires an entity to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. Other borrowing costs are recognised as an expense in the period in which the costs are incurred. However, AASB 123 currently provides that a NFP public sector entity may elect to recognise borrowing costs as an expense in the period in which they are incurred, regardless of how the borrowings are applied.

3 The *Process* states that the purpose of modifying IFRSs for public benefit entities (PBE)/NFP entities is **to reflect differences between the PBE/NFP and for-profit sectors**, including differences in user information needs, that warrant a different accounting treatment or guidance for public benefit and NFP entities [emphasis added]. Paragraph 9 of the *Process* notes that the following two questions would generally be considered before modifying an IFRS:

(a) Are there issues that might warrant modifying an IFRS for PBE/NFP?

(b) Are the identified issues sufficiently significant to warrant a departure from an IFRS?

4 The remainder of this paper is organised as follows:

(a) **Paragraphs 5 to 7** describe the IASB's rationale for issue of IAS 23, and the dissenting views of some of its members, as background information;

(b) **Paragraphs 8 and 9** describe the basis on which the *Process* is premised;

(c) **Paragraphs 10 to 45** set out arguments that staff think are relevant to making the assessment of whether IAS 23 should be modified for application by NFP public sector entities, having regard to the factors listed in the *Process* (nature of the transaction and the costs/benefits of complying with the IFRS);

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1 Refer Agenda Paper 10.5. The Process is also available on the AASB website at: http://www.aasb.gov.au/admin/file/content102/c3/Final_Process_for_modifying_IFRSs_Oct_2009.pdf. The Process was developed jointly with the New Zealand Financial Reporting Standards Board (NZ FRSB; now superseded by the New Zealand Accounting Standards Board) in 2009, which is why it refers to PBE (public benefit entities) as well as NFP entities.

(d) **Paragraphs 46 to 50** set out the staff view and recommendations. The question to the Board is posed after paragraph 50;

(e) **Appendix 1** notes previous reservations that the AASB has expressed in relation to the capitalisation treatment specified by IAS 23. Staff think that these reservations differ from those set out in paragraphs 10 – 45 as these reservations should not affect the Board's assessment against the *Process* as to whether modification of IAS 23 is warranted;

(f) **Appendix 2** provides a status update of the International Public Sector Accounting Standard Board's (IPSASB) project on revising IPSAS 5 *Borrowing Costs*, as the *Process* indicates that International Public Sector Accounting Standards (IPSASs) may provide supporting evidence for modification of IAS 23 for NFP entities; and

(g) **Appendix 3** sets out the approach taken by the New Zealand Accounting Standards Board (NZASB).

## IASB RATIONALE FOR ISSUE OF IAS 23

5 The majority of IASB members considered the benefits of higher comparability, improved financial reporting and in principle convergence with US GAAP to exceed any additional costs of implementation of IAS 23. In its Basis for Conclusions, the majority of the IASB considered that:

(a) capitalisation provides a faithful representation of the cost of the asset; immediate expensing does not;

(b) capitalisation at least improves comparability among all non-equity financed qualifying assets; immediate expensing impairs comparability between assets that are internally developed and those that are acquired from a third party (as the cost of the latter would factor in financing costs of the seller); and

(c) capitalisation does not impose an unnecessarily burdensome cost of implementation; accordingly any additional costs would be offset by the advantage of having all entities account for borrowing costs in the same manner (refer IAS 23.BC9-BC14).

6 Three (3) IASB members dissented from the issue of IAS 23 as they considered the following costs of implementation of the Standard to exceed benefits from its implementation:

(a) the need for cumbersome measurement and monitoring processes over a long period to facilitate capitalisation, which is likely to involve considerable accounting work and incremental auditing costs;

(b) users responding to the proposals saw little informational benefit in a model that capitalises costs (other than the capitalisation of the actual economic cost of capital of the investment); and

(c) a standard requiring the capitalisation of borrowing costs should discuss more extensively which assets qualify for the purpose of capitalising which borrowing costs.

7 Further, these members did not support the limited convergence with US GAAP nor addressing the accounting for borrowing costs as part of short-term convergence with US GAAP, as they considered both IAS 23 *Borrowing Costs* (1993) and the related US requirements to both be in need of significant improvement.

## BASIS ON WHICH THE *PROCESS* IS PREMISED

8 The *Process* (Agenda Paper 10.5) is premised on the Board accepting that an IFRS represents best practice. Accordingly, the *Process*, as currently drafted, does not consider disagreement with a requirement in an IFRS and/or the IASB's reasons for issuing the IFRS to be, in and of itself, an appropriate basis for modification of an IFRS to require or permit an alternative accounting treatment for NFP entities. Instead, the *Process* requires the identification of NFP specific circumstances as the basis for modification.

9 The AASB has previously indicated reservations about the approach specified by IAS 23. The Board at that time considered that the capitalisation approach did not provide higher quality financial reporting to the immediate expensing of all borrowing costs, and that the immediate expensing of borrowing costs is the more supportable conceptual approach. The AASB also disagreed with revising IAS 23 to achieve in-principle convergence with US GAAP. These reservations are described further in Appendix 1, and are not specific to the NFP sector.

## ANALYSIS

10 When considering whether there are issues that might warrant modifying an IFRS for NFP, the *Process* requires consideration of at least the following factors:

(a) nature of transactions, events and circumstances and their impact on NFP;

(b) benefits to users of complying with the IFRS; and

(c) costs of complying with the IFRS.

Arguments for departure from IAS 23 are to be evaluated having regard to the above.

11 There has previously been domestic and international work conducted in relation to whether IAS 23 should be modified for application by NFP public sector entities. More information about these efforts is set out in Appendix 2 (IPSASB) and Appendix 3 (New Zealand) to this Agenda Paper and in Appendix 1 to Agenda Paper 10.4 (Australia, IPSASB). Staff have considered the arguments raised as part of these prior projects.

12 The following are considered as arguments for departure from IAS 23 for public sector entities:

(a) IAS 23 does not facilitate convergence with Government Finance Statistics (GFS) (paragraphs 13 to 17);

(b) borrowings in the public sector are generally made for public policy purposes and there is no nexus between borrowings at a central agency level and individual qualifying assets at the government entity level (paragraphs 18 to 23);

(c) the costs of compliance with IAS 23 – arising from the governance structure, additional tracking necessitated and timely reporting pressures (paragraphs 24 to 30);

(d) the immediate expense approach serves the information needs of users (paragraphs 31 to 40);

(e) the benefits of capitalisation are limited when qualifying assets are measured at fair value (paragraphs 41 to 42); and

(f) it is unclear how capitalised borrowing costs should be treated in a depreciated replacement cost model (paragraphs 43 to 45).

## (a) IAS 23 does not facilitate convergence with GFS

13 The Preface to AASB 1049 *Whole of Government and General Government Sector Financial Reporting* states: "As a result of potential amendments to the requirements in Australian Accounting Standards and the ABS GFS Manual or the interpretation of those requirements, differences between GAAP and GFS not contemplated in this Standard may eventuate … As issues emerge in the future, the Board will have regard to the implications for whole of government financial reporting and GGS financial reporting in deciding whether to amend this or another Standard to either avoid or confirm the existence of a difference." In Australia, all borrowing costs are expensed under current GFS requirements. Accordingly, IAS 23 is not consistent with GFS and will have implications for whole of government (WoG) and GGS financial reporting.

14 One of the main arguments previously put forth by various Australian constituents in favour of modifying IAS 23 to allow the expensing of all borrowing costs as they are incurred has been to reduce the number of differences between GFS and Australian Accounting Standards in the interests of GAAP/GFS harmonisation.

15 A difference between GAAP and GFS in this regard will give rise to additional costs, as WoG and GGS entities would be required to carefully track any reconciling differences over the useful life of public sector infrastructure assets that may have a longer life than most private sector assets[2] to ensure that GAAP is appropriately reconciled to GFS key fiscal aggregates. Such reconciliation differences could include subsequent depreciation impacts, and the determination of whether a net revaluation movement is to be recognised in profit or loss or in other comprehensive income. Some argue that the difference may necessitate the maintenance of two sets of books, at a substantial cost to taxpayers.

16 Staff note that there are already existing differences between the requirements of GFS and Australian Accounting Standards, for example, GFS does not recognise write-downs of accounts receivable in relation to doubtful debts, and requires

2 For example, the State of Victoria 2012-2013 Annual financial report notes that water infrastructure assets are depreciated between 25 to 300 years, and roads and road networks between 60 to 90 years.

inventories to be measured at current prices. The staff recollection is that the Board's general sentiment when the accounting for borrowing costs was previously discussed (before the current project included on the AASB's work programme) was that GAAP/GFS considerations are not an adequate basis for substituting a preferred treatment for the accounting otherwise prescribed by IFRSs.

17 Further, staff note that for-profit entities in the public sector are already subject to the requirements of AASB 123 to capitalise borrowing costs which are directly attributable to qualifying assets, which (if material) would already be required to be monitored and reversed for GFS compliance purposes.

**(b) Borrowings in the public sector are generally made for public policy purposes and there is no nexus between borrowings at a central agency level and individual qualifying assets at the government entity level**

18 The IPSASB noted in its Basis for Conclusions to IPSASB ED 35 *IPSAS 5 "Borrowing Costs" (Revised 200X)* that:

BC5. Borrowing in the public sector is often centralized and borrowing requirements are determined for the economic entity as a whole. Borrowing may be for investing, financing or operating activities. The aggregate level of borrowing will be set in the context of political and economic factors, such as decisions on the appropriate levels of taxation. The funding allocated to specific programs and entities may be derived from a variety of sources, and consequently the resources transferred are often indistinguishable in character. A feature of fiscal management in the public sector is that governments sometimes budget for deficits, occasionally for extended periods of time, and those deficits are financed by borrowing. In many jurisdictions outlays on qualifying assets are a relatively minor part of the government's annual outlays, the bulk of which are consumed by expenses, such as the payment of social benefits to individuals and households. This can be distinguished from the for-profit sector in which entities would normally budget for a loss only in unusual circumstances, and certainly not for an indefinite period. Therefore, in the public sector it is often difficult to distinguish financing from external borrowing and other sources of finance and there is often no meaningful way to attribute borrowing costs to qualifying assets.

BC6. Governments and other public sector entities may borrow for public policy purposes, for example they may issue debt securities to provide liquidity in the capital markets. Often these securities form the benchmark security for the bond market and a common basis for pricing other securities.

BC7. The reasons for public sector borrowing outlined in the preceding paragraphs mean that there is little linkage between these types of borrowing and the acquisition, construction or production of qualifying assets. For example, a government that has a policy of maintaining CU100 billion in bonds in the market, while not actually needing the cash, will find that, if it were required to capitalize borrowing costs, it would capitalize interest for any qualifying assets acquired, constructed or produced in any years in which bonds are outstanding. While it may be feasible to allocate these borrowings to qualifying assets, the IPSASB is of the view that doing so is unlikely to provide relevant and reliable information or enhance accountability. It is also likely that the cost to do so would exceed the related benefits, if any.

19 As part of its December 2008 submission to the IPSASB on IPSAS ED 35, HoTARAC agreed with the IPSASB views noted above, commenting in its submission that:

> "In the Australian public sector, while the Government usually raises taxes and borrows funds on a central basis, it will distribute these funds to departments and other subsidiary entities in a variety of ways, including appropriations, grants, loans and equity contributions. Consequently, the funding position of each subsidiary entity, reflected in its individual financial reports, will vary depending on a mixture of historic and current practice.
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> For public policy purposes, the Australian Government undertakes centralised borrowing to create a bond market, not to fund asset acquisitions. Asset acquisitions are funded from current and previous operating surpluses. Australian State and Territory Governments, on the other hand, may undertake borrowings on top of their Consolidated Revenue Funds, which is then used to fund expenditure across the whole-of-government. There is no nexus between borrowings at a central agency level and individual qualifying assets at the government entity level."

*Borrowing decisions made by centralised borrowing units*

20 Staff are sympathetic to the argument that there is likely to be little or no nexus between centralised borrowings by a central agency and the individual qualifying assets in a government entity. However, staff consider that the raising of finance via a central borrowing unit and the application of funds to group entities is not unique to the public sector. IAS 23.11 acknowledges that centralised borrowing activity may create difficulties in determining whether a direct relationship between particular borrowings and a qualifying asset exists, and that the exercise of judgement is required. The AASB noted in its submission to the IPSASB on IPSAS ED 35:

> "The AASB notes that reasons given for departing from IAS 23 in ED 35 about the difficulty in the public sector of associating borrowings with particular qualifying assets are also issues in the private for-profit sector.
>
> Although issues arise for governments that borrow centrally, similar issues also arise in many large businesses. For example, a private sector parent entity may raise funds through debt and equity sources for a group of companies and then allocate funding to a particular subsidiary for the construction of a qualifying asset. In such a situation, it would be difficult for the entity to distinguish the proportion of debt financing because financing is provided from a pool of funds."

21 In respect of general borrowings, IAS 23.14 states "To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset …". This has generally been interpreted in practice to require application of borrowing activity to qualifying assets acquired during the period, regardless of whether the borrowing was raised with the objective of making capital purchases. That is, a consolidated entity employing a centralised borrowing structure where

borrowings are removed from the qualifying asset (or a decision to acquire the qualifying asset) acquired at a group entity level would still apply interest capitalisation to the qualifying asset at a consolidated reporting level.

*Borrowings made to achieve public policy objectives*

22 Staff agree that public sector borrowing may be actioned mainly for public policy purposes, such as encouraging activity in a domestic bond market, in which case there is likely to be little or no nexus between centralised borrowings by a central agency and the individual qualifying assets. Staff also agree that expensing borrowing costs as incurred would more accurately reflect the *objective* of borrowings made to meet public policy objectives.

23 However, in considering the above against the *Process*, staff note that IAS 23.11 (AASB 123.11)[3] and IAS 23.14 (AASB 123.14)[4] acknowledge that private sector entities may incur general borrowings that may not have been made for the purposes of acquiring a qualifying asset. Staff think that borrowings made to meet public policy objectives are similar to general borrowings contemplated by the Standard in that the objective behind the borrowing may not have been made for reasons of asset acquisition; i.e. the reason for raising the funds is not relevant. For example, a for-profit entity may have initially chosen to borrow to maintain a certain debt/equity ratio or to avoid dilution of equity.

## (c) The costs of compliance with IAS 23

24 Staff note that, while not adopted in Australia, the *IFRS for SMEs* requires entities to expense all borrowing costs; the IASB noting in paragraph BC120 to its Basis for Conclusions to the IFRS that expensing is required for cost-benefit reasons. Similarly, some argue that the approach included in IAS 23 should be modified for NFP public sector entities for cost-benefit reasons.

25 While centralised borrowing may not be unique to the public sector, the costs of compliance with IAS 23 may be seen as being more burdensome for public sector entities compared to the private sector due to dissimilarities in organisation and structure and additional reporting obligations. Some argue that the capitalisation

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3 AASB 123.11 states "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 a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required."

4 AASB 123.14 specifies "**To the extent that an entity borrows funds generally and uses them 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 asset. The capitalisation rate shall 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 that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.**"

model would be extremely difficult and costly to implement in the public sector due to the substantial differences between public and private sector governance structures.

26 Staff had regard to the then Australian member to the IPSASB's comments made in an IPSASB Agenda Paper (made while the IPSASB was deliberating the proposals to be included in IPSASB ED 35).[5] The member commented:

> "The third concern, which is where with my experience both in the private sector and government I would refute [IPSASB] staff's opinion, is that additional compliance costs for the public sector would not be significantly different, presumably because of the similarity between a government undertaking central borrowing and a company group doing the same. While on the face of it the situations are very similar, the difference in organization and structure between say a listed profit seeking company and a government has a very different outcome. The listed company is only likely to have a few subsidiaries that undertake the construction of qualifying assets. All subsidiary entities will have boards that largely are made up either of board members of the parent entity or of management staff. The entire economic entity will act in a disciplined way and in particular will follow group policies and use common systems that, inter alia, produce regular financial and management reports both for individual entities and the entire group. In such a group, funding of subsidiaries will probably be made in the most tax effective way, but it will also be relatively simple to keep track on different bases for different reporting purposes. Moreover, the qualifying assets concerned will have depreciable lives that rarely exceed two or three decades. Those private sector economic entities affected by this standard generally will have the resources to handle the problem and can probably minimize the cost and impact.
>
> By contrast, governments may have scores of subsidiary entities, with many of them constructing qualifying assets with depreciable lives of many decades. Although there will be a need to follow the general policies of government, many of these entities will have been set up deliberately with local, largely independent management boards. They are likely to have independent accounting resources and systems. And of course there is independence, competition and often inconsistency of reporting between departments and portfolio entities reflecting independence and equality between ministers under the Westminster system. Accounting and management systems in many jurisdictions reflect local and departmental reporting requirements, with occasional population of a summarized chart of accounts for whole of government reporting. Funding to departments is by means of parliamentary appropriation from a central fund without concern whether the fund holds monies from taxes or borrowed funds. The departments in turn either spend the appropriations or pass them on as grants. They may also allow subsidiary entities to borrow, usually from a central agency. Any system of accounts and records to track directly and indirectly attributable borrowing costs, their application to qualifying assets, and the subsequent depreciation impacts would be complex, resource demanding and costly."

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5 Refer Peter Batten's comments in IPSASB Agenda Paper 7.0.2 (March 2008), available at http://www.ifac.org/sites/default/files/meetings/files/3760.pdf

27 Staff think the member's sentiments are reflected in IPSASB ED 35.BC8, which notes:

> BC8. In the public sector controlling entities may have a large number of controlled entities. Many of these controlled entities are responsible for acquiring, constructing or producing qualifying assets. Although there will be a general policy framework, many controlled entities are likely to have their own financial management systems, reflecting their own reporting needs. Funding for such controlled entities may be by means of appropriation from a central fund without regard to whether such appropriations are financed from taxes, borrowings or other sources. Any accounting system to track directly attributable borrowing costs and their application to qualifying assets is likely to be complex and resource intensive. The IPSASB is of the view that in these cases, the costs incurred in capitalizing borrowing costs would be likely to exceed the related benefits, if any.

28 Staff understand that NFP public sector entities in Victoria are generally funded via contributions by owners, rather than debt. This is regardless of whether the owner (State of Victoria) borrowed funds that were then applied to group entities. Accordingly, the removal of the option to immediately expense all borrowing costs is expected to have little impact on entity-level reporting, but will create complexities for consolidated financial reporting. A concern is that the State does not hold sufficient information to identify costs that may relate to qualifying assets. Therefore, effort will be required to identify and determine the required associated interest capitalisation at a consolidated State level, and resultantly that significant additional costs would be necessary to maintain additional record-keeping to obtain this information.

29 A further concern is the additional pressure on the ability of public sector preparers to achieve timely reporting as part of complying with IAS 23.

30 Staff note that in Australia, the relevant Australian Accounting Standard applicable to the borrowing costs of government entities pre-IFRS adoption was AAS 34 *Borrowing Costs* (which is consistent with AASB 1036 *Borrowing Costs*), issued jointly by the Public Sector Accounting Standards Board (PSASB) and the AASB. AAS 34 required the capitalisation of all borrowing costs that were directly attributable to the acquisition, construction or production of qualifying assets, and the expensing of all other borrowing costs as they were incurred. AAS 34 applied from reporting periods ending on or after 31 December 1998 until superseded by AASB 123 *Borrowing Costs* (July 2004) on adoption of IFRSs in Australia. While past practice is not itself a justification for future requirements, staff think that arguments for departure from IAS 23 for reasons of costs and complexity should be considered in the context of there being a previously existing requirement for Australian government entities to apply an accounting policy for borrowing costs that is largely similar to IAS 23. However, staff also note that WoG and GGS entities were not previously required to provide a reconciliation between GAAP and GFS, and that application of AAS 34 may have been regarded as less burdensome than in the current environment.

### (d) The immediate expense approach serves the information needs of users

31 The *Process* notes that one of the factors to be considered in assessing whether modification is necessary is the benefits of compliance to users. Paragraphs 16-19 of

the *Process* require evaluation of potential benefits for users of compliance with an IFRS against material in the IASB's Basis for Conclusions that identifies the benefits for for-profit entities.

32 The IASB's reasons for issuing IAS 23, and the dissenting opinions of various IASB members, were set out in paragraphs 5 to 7 above. In accordance with the *Process*, staff evaluated these stated benefits of requiring capitalisation as well as the basis for IAS 23 dissenting opinions. Staff think that, with the exception in paragraph 7 (convergence with US GAAP), the IASB reasons for and against capitalisation apply equally in respect of both for-profit and NFP entities. Accordingly, compliance with IAS 23 for the reasons set out in the IASB's Basis for Conclusions to IAS 23 does not compromise a NFP public sector entity's provision of information about service delivery, sustainability, or efficiency and productivity.

33 However, staff then considered whether there are other reasons why the immediate expense approach would better enable a NFP public sector entity to provide information about service delivery, sustainability, or efficiency and productivity.

34 Paragraph AusOB3.1 of the Appendix to the *Framework for the Preparation and Presentation of Financial Statements* notes that users of NFP general purpose financial reports are generally not concerned with obtaining a financial return on an investment in the entity, but are concerned with the ability of the entity to achieve its objectives (whether financial or non-financial), which in turn may depend, at least in part, on the entity's prospects for future net cash inflows. Users will, for example, be interested in the capability of the entity's resources to provide goods and services in the future. Similarly, the *Process* recognises that user needs for information will differ between for-profit and NFP entities. Paragraph 16 of the *Process* states that users of NFP financial reports are likely to be especially interested in an entity's:

(a) service delivery – being the quality of the goods and services produced and whether this level of quality is appropriate;

(b) efficiency and productivity – being more likely to involve information that is based on costs and on information about outputs/outcomes that may be non-financial in nature; and

(c) sustainability – because the sustainability of a NFP entity is more likely to depend on it meeting its mission than on its profits and profitability, whereas the sustainability of a for-profit entity is primarily dependent on financial performance.

*Sustainability of expenditure*

35 In GFS, the sustainability of expenditure is often reflected by disclosure of the GFS fiscal aggregate 'net debt', which is included in the balance sheet and represents an indicator of risk and sustainability. Some argue that expensing borrowing costs is consistent with this information need, as it better reflects the costs of benefits received and decisions made, and therefore allows users to better assess the future fiscal sustainability of decisions. This is important for the discharge of accountability where users have less ability to make resource allocation decisions compared to users of general purpose financial reports of a for-profit private sector entity.

36 Staff note that interest expense is an aggregate disclosed in GFS operating statements, and that 'net debt' is not a specified disclosure in AASB 1049.

*Purpose of constructing the qualifying asset*

37 A rationale for capitalisation (in the context of a cost model) is that it better reflects the cost of the asset by capturing the full cost of construction for qualifying assets financed via borrowed funds. This is useful in decision making where the purpose of the construction is to achieve a financial return for the entity. Conversely, NFP public sector entities may undertake the construction of certain qualifying assets for objectives other than achieving a financial return, for example, the construction of a public library, and these objectives may be monitored and assessed separately from the financial return from that asset.

38 Some argue that users are more interested in whether the qualifying asset meets service delivery objectives than whether the cost of an asset appropriately reflects the cost of borrowing. Supporters of this view consider that asset cost is of lesser importance in NFP public sector entities that make asset acquisition decisions where the achievement of financial returns is not the key objective, regardless of whether for-profit users may also benefit from the resultant qualifying asset (for example, roads) and indirectly gain for the NFP public sector entity a financial return on its asset (for example, via taxation of profits).

*Comparability*

39 The option to immediately expense borrowing costs allows for comparisons to be made between government jurisdictions to assess the performance of a NFP entity. While requiring NFP public sector entities to apply the capitalisation approach in IAS 23 would support transaction neutrality, some argue that it would reduce comparability of results between jurisdictions, and may create the need to introduce reconciliations to allow such comparisons to be made.

40 Some argue that given the information needs of users of general purpose financial reports of NFP public sector entities described (sustainability and non-financial objective achievement), the simpler approach of immediately expensing all borrowing costs is sufficient to reflect the information needs of users of general purpose financial reports of NFP public sector entities.

### (e) The benefits of capitalisation are limited where qualifying assets are measured at fair value

41 In the main, at a WoG level, qualifying assets are subsequently measured on the fair value basis for consistency with GFS requirements.[6] Accordingly, some argue that any benefits to users of requiring NFP public sector entities to capitalise borrowing costs attributable to qualifying assets may largely be lost after initial measurement of the asset, such that the costs of compliance may be substantially more than the benefits of compliance with IAS 23.

6 Cost is used for some assets because the agency is transitioning to fair value (e.g. defence weapons platforms) or because cost and fair value are not materially different in some cases.

42 Staff agree that, where qualifying assets are measured on the fair value basis after initial recognition, there would appear to be little or no benefit from including borrowing costs in the initial measurement of the asset.[7] This is consistent with the IASB's rationale in excluding qualifying assets measured at fair value from the scope of IAS 23.

**(f) It is unclear how capitalised borrowing costs should be treated in a depreciated replacement cost model**

43 Some constituents have previously queried the relationship between depreciated replacement cost and fair value, and how borrowing costs are treated in a depreciated replacement cost model, and consider that practice should not be amended until such issues have been resolved. Staff note that the International Valuation Standards Council Technical Information Paper (TIP) 2 *The Cost Approach for Tangible Assets* was issued in 2012. TIP 2 suggests that the finance costs of typical market participants (or where appropriate, the opportunity cost of using own capital) should be included in a depreciated replacement cost model.

44 The Board is also currently considering various implementation issues in relation to the determination of the fair value of assets of NFP entities in accordance with AASB 13 *Fair Value Measurement* (see Agenda Item 16), including the relationship between depreciated replacement cost in AASB 13 and depreciated replacement cost as referred to in other Australian Accounting Standards. Staff think that deferring the accounting for borrowing costs of NFP public sector entities pending the outcome of the work of the Board in this area may be consistent with one of the Board's rationales for the relief granted in AASB 2009-1 *Amendments to Australian Accounting Standards – Borrowing Costs of Not-for-Profit Public Sector Entities* (April 2009), where the Board considered that the immediate expensing approach should be permitted pending the outcome from an active current NZ FRSB project on the relationship between depreciated replacement cost and borrowing costs.

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7 Staff note that an accounting policy commonly applied to assets under construction (which may qualify as qualifying assets) is to measure such assets at cost. Staff consider that some of the stated concerns of applying the capitalisation approach would be minimised if assets under construction were measured on the fair value basis.

Staff have mixed views as to whether assets under construction which are within the scope of AASB 116 *Property, Plant and Equipment* can be measured on the fair value basis. Some staff are of the view that by scoping investment properties under construction out of IAS 16 and into IAS 40 *Investment Properties*, and allowing these assets to be measured at fair value while under construction (equivalent amendments were made in AASB 2008-5 *Amendments to Australian Accounting Standards arising from the Annual Improvements Project* (July 2008)), the IASB has signalled that other assets under construction within the scope of IAS 16 (and similarly, AASB 116) are required to be measured at cost until the asset is completed. Other staff consider that AASB 116 is silent as to the accounting for assets under construction, and that once an entity recognises an asset within the scope of AASB 116, including an incomplete asset that is not yet ready for use in its present form, the fair value basis is available as the asset has now passed from the 'initial recognition' stage into the 'measurement after recognition' phase. That is, for example, some staff would argue that a bridge under construction can be measured at fair value only once the bridge asset is completed, whereas others are of the view that a bridge under construction can be measured at fair value at any time during the construction process. Staff think that whether assets under construction can be measured at fair value and thereby minimise some of the concerns of applying the capitalisation approach espoused by IAS 23 is not necessarily relevant in assessing IAS 23 against the *Process*, however have included mention of it in this paper for completeness.

45 However, staff also consider that the determination of fair value (including depreciated replacement cost where representative of fair value) is a **subsequent measurement basis** and does not change the **measurement on initial recognition** of a qualifying asset. Accordingly, while there is a relationship between IAS 23 and the Board's work on depreciated replacement cost, it may not be necessary to defer this project for any outcomes of that work.

## STAFF VIEW

46 In deciding whether issues are sufficiently significant to warrant a modification to IAS 23 for application by NFP public sector entities, the *Process* requires consideration of:

(a) an estimate of the significance of any modification on the financial statements;

(b) an estimate of the significance of a transaction, event or circumstance on the financial statements taken as a whole;

(c) whether or not a modification will increase or decrease internal consistency within IFRSs as modified for PBE/NFP; and

(d) the costs of preparing the modification and the costs of requiring preparers, auditors and users to learn and apply two sets of requirements.

47 On balance, based on the analysis in paragraphs 10 to 45, staff are of the view that there are insufficient NFP public sector specific reasons for departing from the requirements of IAS 23, as:

(a) departure from GFS requirements is not a valid reason to depart from IFRSs;

(b) for-profit entities similarly employ centralised borrowing structures;

(c) for-profit entities may also make borrowing decisions to meet an objective unrelated to asset acquisition;

(d) arguments of costs and complexity, the rationale for borrowing by public sector entities and the information needs of users, can be challenged since the previous (AAS 34) requirements for Australian government entities required borrowing costs directly attributable to the acquisition, construction or production of qualifying assets to be capitalised; and

(e) staff do not think that it is necessary to defer this project for any outcomes of the Board's work on depreciated replacement cost.

48 Staff note that many of the arguments raised in support of modifying IAS 23 were made by Federal and State constituents. Staff also note that local government entities borrow to raise finance for qualifying asset acquisition activity and that some councils currently apply the capitalisation approach rather than the option to immediately expense borrowing costs. Staff consider that modification of IAS 23 for local government entities would be inappropriate given their borrowing activity, and consequently staff do not support modification of IAS 23 for NFP public sector entities.

49 The staff view is consistent with the AASB’s previous decision to incorporate IAS 23 unamended for NFP public sector entities in June 2007 and its comments in its previous submission to the IPSASB on IPSASB ED 35.

50 Staff recommend that the Board amend AASB 123 to require NFP public sector entities to apply the same accounting policy for borrowing costs as for-profit entities. That is, to align the requirements of AASB 123 and IAS 23 for NFP public sector entities.

**Question for Board Members:**

Do Board Members agree with the staff view in paragraph 50? If no, how do Board Members wish to proceed with this project?

# APPENDIX 1
## Previous Reservations Expressed of Limiting AASB 123 to only the Capitalisation Approach (Non-Public Sector Specific)

1 The *Process* acknowledges that the mere fact that the AASB prefers a different requirement from that reached by the IASB on an issue will rarely be a sound basis for modifying an IFRS for PBE/NFP, and that disagreement with the IASB's treatment is unlikely to provide a good reason, in and of itself, for changing the requirement in an IFRS – modifications should arise from differences between sectors, user needs and cost-benefit considerations.

2 The Board issued AASB 123 *Borrowing Costs* in July 2007, indicating that the Board did not regard its reservations with the IASB's treatment to provide sufficient reason for departing from IAS 23 for for-profit entities. Staff do not consider these reservations to be sector specific, and accordingly, hold the view that the AASB's disagreement with the IASB's treatment does not provide a good reason, in and of itself, for changing the requirement in IAS 23. However, staff think that this paper would not be complete without at least acknowledging the Board's previous reservations to the capitalisation treatment specified by IAS 23 *Borrowing Costs*, and accordingly have summarised these below.

Not demonstrably of a higher quality to 'immediate expense' option

3 In its September 2006 submission to the IASB on the proposals that were finalised in IAS 23, the AASB expressed disagreement with the IASB's proposed treatment of borrowing costs as, among other things, it considered that the IASB had not demonstrated how capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset produces accounting of a higher level to that when such borrowing costs are immediately expensed.

Conceptually inconsistent

4 The AASB also noted in its submission to the IASB that it did not believe that the proposals that were finalised in IAS 23 reflect the best conceptual outcome. In responding to the IPSASB in December 2008 on IPSASB Exposure Draft 35 *IPSAS 5 "Borrowing Costs" (Revised 200X)*, the AASB at that time expressed the view that conceptually, it did not support treating borrowing costs differently from other financing costs. While it considered that there were some conceptual arguments for capitalising all financing costs (including borrowing costs and notional costs of equity financing), the AASB believed that the weight of conceptual argument supported the view that borrowing costs should be immediately expensed as a period cost, as they represent an element of the cost of financing an entity's collective activities for a period and also the cost of the return due to the lender for the funds held by the entity for a certain period.[8]

5 Others have similarly argued that eliminating the 'immediate expense' option would not result in improved comparability between entities, noting also that borrowing costs directly attributable to qualifying assets would be treated differently from borrowing

8 Refer AASB submission to IPSASB ED 35: http://www.aasb.gov.au/admin/file/content106/c2/IPSASB_ED35_submission.pdf

costs that are directly attributable to non-qualifying assets (although the nature of the asset should not affect the components of its cost), and that comparability between assets that are internally developed and those that are acquired from a third party would be affected by any profit margin of the vendor. The capitalisation approach also results in similar assets being carried, when complete, at different amounts depending on the financing method adopted – an entity with a large proportion of equity capital may carry its fixed assets at a lower amount than an entity that is highly leveraged.

Achieves limited convergence with US GAAP

6 The AASB also objected to the IASB's revision of IAS 23 to eliminate the 'immediate expense' option then available as the IASB project achieved only 'in principle' convergence with US GAAP with regards to the accounting for borrowing costs, as there were other dissimilarities not addressed as part of the project, for example, the definitions of 'qualifying asset' and 'borrowing costs'.

# APPENDIX 2
# IPSASB Borrowing Costs Project

1 Paragraph 11 of the *Process* notes that a modification to an IFRS, based on one of the factors considered by the *Process*, may be made in an IPSAS. This would provide supporting evidence that there is a PBE issue that might warrant modifying an IFRS for PBE/NFP, subject to understanding the original rationale of the IASB and the reason why the modification was made by the IPSASB.

2 The IPSASB undertook a project to revise IPSAS 5 *Borrowing Costs* (May 2000) following the issue of IAS 23 in March 2007. IPSASB ED 35 differed significantly from IAS 23 as the IPSASB decided that it was inappropriate to require public sector entities to capitalise borrowing costs for reasons set out in the Basis for Conclusions to the ED. The ED instead proposed retaining an option to allow entities to capitalise borrowing costs, but amending IPSAS 5 to only permit borrowing costs that are 'specifically incurred' (rather than the broader 'directly attributable') for the acquisition, construction or production of a qualifying asset to be capitalised.

3 The AASB's submission to the IPSASB on IPSASB ED 35 noted that the AASB was concerned that the IPSASB had not identified sufficient public sector specific reasons for departing from IAS 23. The IPSASB received mixed responses to its ED and agreed that it would be inappropriate to develop a Standard reflecting the ED's proposals without further work. The IPSASB has since deferred its Borrowing Costs project until completion of the IPSASB Conceptual Framework, expected later in 2014. The IPSASB has not yet decided when to reactivate this project.

4 Accordingly, at this time, as the IPSASB has not yet revised IPSAS 5 to converge with IAS 23 (March 2007), staff consider that the existing IPSASs do not provide supporting evidence that there is a public benefit entity issue that might warrant modifying IAS 23 for PBE/NFP. However, staff considered the arguments put forth by the IPSASB in IPSASB ED 35 in support of a modification in its testing of IAS 23 against the *Process*.

# APPENDIX 3
# Approach taken by New Zealand

1 The *Process* was developed jointly between the AASB and the former New Zealand Financial Reporting Standards Board (FRSB).[9] Although the *Process* acknowledges that the FRSB and the AASB will not necessarily come to similar conclusions about whether a modification to an IFRS is warranted, for completeness the approach taken by New Zealand is documented here.

2 In November 2008, the FRSB decided to defer the application of NZ IAS 23 *Borrowing Costs* (incorporating IAS 23 *Borrowing Costs*) to public benefit entities. To assist the FRSB in making its decision, FRSB staff had tested IAS 23 against the then draft criteria in the *Process* (similar to the analysis in this Agenda Paper). The AASB was provided with a copy of the FRSB staff analysis. The FRSB noted in its Basis for Conclusions accompanying NZ IAS 23 that deferral was appropriate as it was (then):

(a) currently undertaking a high priority project on the application of NZ IAS 23 by public benefit entities; and

(b) in the process of considering appropriate guidelines on modifying IFRSs for public benefit entities.

3 In relation to paragraph 2(a), since then, in line with its move to a new accounting standards framework, for periods beginning on or after 1 December 2012 until periods beginning on or before 30 June 2014, Tier 1 and Tier 2 NZ public sector public benefit entities (NZ PS PBE), including governments, were required to comply with NZ IAS 23 *Borrowing Costs* (PBE). This Standard incorporated IAS 23 but did not require PBEs to apply the Standard, but permitted such entities to instead expense borrowing costs directly attributable to qualifying assets.

4 From 1 July 2014, NZ PS PBEs are required to comply with PBE IPSAS 5 *Borrowing Costs*. This Standard incorporates IPSAS 5 *Borrowing Costs* (May 2000), and permits the immediate expensing of all borrowing costs as the benchmark treatment.

5 Paragraph 2(b) was completed with the issue of the *Process*.

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9 Superseded by the NZ Accounting Standards Board.