Staff Paper

March 2011, Joint Agenda Paper J4.2

Borrowing Costs and Depreciated Replacement Cost in Fair Value Measurements

Purpose of this Paper

1. This paper focuses on the questions of:

   (a) whether the current PBE/NFP exemptions[1] in AASB 123/NZ IAS 23 *Borrowing Costs* should be retained once the domestic Standards incorporating IFRS 13 *Fair Value Measurement* are issued; and

   (b) assuming the exemptions are retained, whether there should be a PBE/NFP-specific modification in AASB 123/NZ IAS 23 to specify the treatment of borrowing costs within a DRC valuation used for initial and subsequent measurement.

Forthcoming IFRS 13

2. The IASB is expected to issue IFRS 13 in April 2011. Other than this agenda item, the Boards are considering some domestic issues in their separate meetings.

   (a) The FRSB will consider a recommendation that all the PBE-specific DRC guidance in NZ IAS 16 be deleted.

   (b) The AASB will consider issues (other than the issue that is the subject of this paper) relating to the application of the forthcoming IFRS 13 to the not-for-profit (NFP) sector and decide whether an NFP modification should be made to the Australian Standard that is expected to incorporate IFRS 13 and, if so, how to progress the work.

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[1] Appendix A of this paper provides an historical background to the current PBE/NFP exemptions in AASB 123/NZ IAS 23 *Borrowing Costs*. Appendix B of this paper reproduces the current PBE/NFP exemptions in AASB 123/NZ IAS 23 *Borrowing Costs*.

Retention of PBE/NFP exemptions in AASB 123/NZ IAS 23

Current treatment of borrowing costs for PBE/NFP

3. The mandatory adoption of NZ IAS 23 (revised 2007) by PBEs was deferred pending research into the application of NZ IAS 23 (revised 2007) by PBEs. The amendments allowed PBEs to continue to expense borrowing costs if they had so elected under NZ IAS 23 (2004) and not to include borrowing costs in the determination of fair value using DRC under NZ IAS 16.

4. In December 2008 the AASB deferred the withdrawal of the option to expense borrowing costs for public sector NFPs. The AASB decided that it would determine whether public sector NFPs should conform to the treatment of borrowing costs by other entities once the IPSASB finalises a revised standard on borrowing costs and the AASB has considered its suitability in an Australian context in light of the outcome of the FRSB/AASB DRC work and the *Process for Modifying IFRSs for PBE/NFP*.

Staff analysis and recommendations

5. As noted in Appendix A, consistent with the *Process for Modifying IFRSs for PBE/NFP*, cost-benefit issues were the most pressing concerns leading to deferral of NZ IAS 23 by PBEs for the FRSB. For the AASB, the interrelationship between the revaluation model commonly adopted by public sector NFPs, the use of DRC within that model, and conceptual concerns about the capitalisation of borrowing costs was the main reason for AASB deferring the withdrawal of the option to expense borrowing cost for the NFP public sector entities. Staff do not consider that IFRS 13 would change any of these fundamental reasons.

6. Staff are therefore of the view that the issuance of domestic Standards incorporating IFRS 13 should not affect the current exemptions in AASB 123/NZ IAS 23 from mandatory capitalisation of borrowing costs. This does not mean a final decision should be made by the Boards at this stage on whether those exemptions should be retained. A final decision should be made after completion of the Measurement chapter of each Board's Conceptual Framework, having regard to the IPSASB's consideration of

borrowing costs in the measurement phase of its Conceptual Framework project, and after the Boards undertake further study of cost/benefit considerations.

Q1	Do you agree that the current PBE/NFP exemptions in AASB 123/NZ IAS 23 *Borrowing Costs* should be retained once the domestic Standards incorporating IFRS 13 are issued, at least until the completion of the Measurement chapter of each Board's Conceptual Framework?

Treatment of Borrowing Costs – Initial and Subsequent Measurement

Background

7. This section of this paper assumes that the current PBE/NFP treatments in AASB 123/NZ IAS 23 are retained (i.e. the Board's response to Q1 above is 'yes') and considers whether PBEs/NFPs applying those treatments should be required to adopt a 'consistent' approach to the treatment of borrowing costs in initial recognition and any subsequent measurement of property, plant and equipment (PP&E).

8. Some argue that to be 'consistent':

   (a) if an entity initially measures an asset at cost without capitalising borrowing costs, when DRC is used for subsequent measurement, DRC should also exclude borrowing costs; and

   (b) if an entity initially measures an asset at cost inclusive of capitalised borrowing costs, then when DRC is used for subsequent measurement, DRC should also include borrowing costs.

9. NZ IAS 16 currently provides guidance on the treatment of borrowing costs in a subsequent DRC valuation (see paragraph NZ 33.14 below). AASB 116 is silent on this issue.

> NZ 33.14 If an entity elects to capitalise borrowing costs in accordance with NZ IAS 23, an amount equal to the amount of borrowing costs that would be embodied in the fair value of the asset is included as a component of depreciated replacement cost. The inclusion of such an amount as a component of depreciated replacement cost is <u>consistent</u> with the principle underlying the inclusion in the initial cost of an asset of borrowing costs eligible for capitalisation as permitted by NZ IAS 23. The amount to be included as a component of depreciated replacement cost is determined on the basis of the average debt-to-equity ratio and average cost of debt applicable to entities undertaking the same activities as the entity reporting. [emphasis added]

10. Consistency is not a qualitative characteristic in the IASB Framework 2010. However, it is linked to the qualitative characteristic of comparability, as stated in paragraph QC22 of that Framework.

QC22 Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

11. As evident from Appendix B of this paper, PBEs/NFPs have a choice to capitalise or expense borrowing costs to qualifying assets on initial measurement. They would then apply the domestic Standards incorporating IAS 16 and the forthcoming IFRS 13 for subsequent measurement. Many NFP/PBEs currently use DRC for subsequent measurement, which the International Valuation Standards Council (IVSC) refers to as the most common application of the cost approach. IFRS 13 [pre-ballot draft] provides very limited guidance on the cost approach and does not explicitly address the treatment of interest in a DRC valuation. Some might argue that PBE/NFP entities would therefore have a choice of whether to include borrowing costs in subsequent measurement of DRC. It is noted that IVSC Exposure Draft *Proposed Technical Information Paper 2: Depreciated Replacement Cost* (ED TIP 2) requires valuers performing DRC valuations to include borrowing costs (refer paragraphs 16 and 17 of ED TIP 2 reproduced in agenda paper J4.4).

Staff analysis and recommendations

12. Some staff are concerned that permitting different treatments of borrowing costs at initial and subsequent measurement would introduce inconsistency. The impact of this inconsistency in treatment on initial recognition and subsequent measurement at fair value would depend on the significance of the directly attributable borrowing costs on qualifying assets in relation to the overall carrying amount of the asset. For public sector entities with large infrastructure assets (especially those with a long acquisition/construction period), the choice in treatment of borrowing costs could be significant and could result in material change in carrying amounts at the point of the first DRC valuation.

13. However, other staff would not characterise the potential outcome as an inconsistency noting that different measurement models are adopted at initial recognition and subsequent measurement. On initial recognition, PP&E is measured at cost that is determined in accordance with AASB 123/NZ IAS 23 which gives PBE/NFP public sector entities a

choice of capitalising or expensing borrowing costs for the purposes of determining cost. On subsequent measurement, PBE/NFP public sector entities that opt to measure PP&E using the revaluation model would often use DRC as a measure of fair value. If borrowing costs were to be excluded from a DRC valuation that purports to be fair value, it would raise a serious question of whether the measure was actually a fair value measure. Hence, the perceived inconsistency by some is attributable to a difference in measurement models.

14. Moreover, these staff consider that fair value measured by reference to DRC should include an appropriate amount of borrowing costs, and ED TIP 2 supports this. They further note that for-profit entities using DRC-based fair values may treat borrowing costs differently on initial and subsequent measurement. At initial recognition the entity would include actual borrowing costs as required by IAS 23 and at subsequent measurement a fair value would have regard to the interest likely to be incurred by a typical market participant. Therefore, ‘consistency’ may not be fully achieved in any event, any sector.

15. As evident from the contrasting views in paragraphs 12-14 staff views are mixed on whether to modify the domestic Standards incorporating IFRS 13 to require that PBEs/NFPs adopt the same treatment of borrowing costs on initial measurement under AASB 116/NZ IAS 16 and any subsequent DRC valuation. However, if the Boards decide that a modification is warranted, possible wording of such a requirement could read something along the following lines:

> Proposed domestic requirement
> Aus80.1/NZ 80.1
> **If a not-for-profit public sector entity [Australia]/PBE [NZ] elects to recognise borrowing costs as an expense in the period in which they are incurred, the entity shall accordingly exclude borrowing costs from subsequent depreciated replacement cost valuation in accordance with the cost approach.**

Q2 If the answer to Q1 is yes, do you think PBEs/NFPs applying the exemptions in AASB 123/NZ IAS 23 should adopt a consistent approach to the treatment of borrowing costs on initial measurement under AASB 116/NZ IAS 16 and any subsequent DRC valuation?

Q3	If the answer to Q2 is yes, do you think the most appropriate way of achieving consistency in the treatment of borrowing costs on initial measurement and subsequent DRC valuations would be to insert a PBE/NFP-specific requirement in the domestic Standards incorporating IFRS 13?
Q4	If the answer to Q3 is yes, do you support the wording of the proposed exemption provided at the foot of paragraph 15 above?

APPENDIX A: Background To Current PBE/NFP Exemptions in AASB 123/NZ IAS 23 *Borrowing Costs.*

IASB issues IAS 23 (revised 2007) – March 2007

In March 2007 the IASB issued a revised IAS 23 *Borrowing Costs* which eliminated the option to recognise all borrowing costs immediately as an expense. It mandated the capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset.

AASB 123/NZ IAS 23 (revised 2007) issued – July 2007

Both the AASB and the FRSB disagreed with the IASB's proposals, as set out in the Exposure Draft of Proposed Amendments to IAS 23, in their submissions. Both Boards recommended that the IASB conduct a more detailed project to consider the treatment of borrowing costs.

The AASB believed that:

(a) the removal of the expense option in IAS 23 would result in an accounting that is still noticeably different from the requirements of SFAS 34; and

(b) the IASB had not shown that the capitalisation treatment is superior to the expense treatment and that short-term convergence should be pursued only in situations where the accounting treatment is superior to that which previously existed.

The FRSB expressed the view that the IASB was promoting change for the sake of convergence without a thorough consideration of the conceptual arguments for and against capitalisation.

Nevertheless, following the IASB's decision to proceed with these amendments, both the AASB and the FRSB had a policy to develop revised domestic standards adopting the requirements of IAS 23 (revised 2007) for profit-oriented entities. The Boards also had an obligation to consider whether any PBE/NFP-specific changes were warranted. The Boards' *Process for Modifying IFRSs for PBE/NFP ('the Process')* had not been developed at that time. The FRSB also needed to consider differential reporting concessions.

Both Boards issued domestic Standards incorporating IAS 23 (revised 2007) with no modifications for NFP/PBE. In New Zealand, entities that qualified for differential reporting concessions were permitted to expense all borrowing costs. The revised NZ IAS 23 also resulted in consequential amendment to the New Zealand specific DRC guidance in NZ IAS 16.

New Zealand defers application of NZ IAS 23 (revised 2007) by PBEs – October 2008

Following the approval of domestic Standards incorporating IAS 23 (revised 2007), public sector constituents continued to express concerns about the mandatory capitalisation of borrowing costs, including the appropriate treatment of borrowing costs in a DRC valuation and the costs and benefits of capitalising borrowing costs. In New Zealand the Office of the Controller and Auditor General (OAG) raised concerns about matters such as the reliability of valuations, the scope of audits and the costs and benefits of compulsory capitalisation. These concerns, particularly cost-benefit concerns, were conveyed to the Accounting Standards Review Board (ASRB). Two other public sector representative bodies in New Zealand also requested that the FRSB defer application of the NZ IAS 23 by PBEs.

In August 2008 the ASRB requested the FRSB reconsider application of the revised IAS 23 to PBEs, making use of amended criteria set out in ASRB Release 8 and having regard to the work being undertaken to develop the *Process*.

In October 2008, the mandatory adoption of NZ IAS 23 (revised 2007) by PBEs was deferred pending research into the application of NZ IAS 23 (revised 2007) by PBEs. The amendments allowed PBEs to continue to expense borrowing costs if they had so elected under NZ IAS 23 (2004) and not to include borrowing costs in the determination of fair value using DRC under NZ IAS 16.

AASB defers application of AASB 123 by public sector NFPs – December 2008

In December 2008 the AASB considered a request by a public sector representative group and agreed to defer the withdrawal of the option to expense borrowing costs for public sector NFPs. In making this decision the AASB noted that:

(a) there is an interrelationship between the revaluation model commonly adopted by public sector NFPs, the use of DRC within that model, and the capitalisation of borrowing costs;

(b) the FRSB intended to undertake work on the relationship between DRC and borrowing costs, and the outcome of that work may inform the AASB on the appropriate treatment of borrowing costs in the public sector (the AASB agreed to participate in the FRSB's work);

(c) the FRSB had deferred the withdrawal of the option to expense borrowing costs for PBEs;

(d) the AASB was still developing its draft *Process* [for modifying IFRSs], and the treatment of borrowing costs would provide a test case for that *Process* once it is developed, particularly in light of the fact that the AASB does not support the mandatory capitalisation treatment of borrowing costs on conceptual grounds;

(e) the International Public Sector Accounting Standards Board (IPSASB) had a project that is considering the treatment of borrowing costs by public sector NFPs; and

(f) expensing borrowing costs is consistent with the GFS Manual.

The AASB decided that it would determine whether public sector NFPs should conform to the treatment of borrowing costs by other entities once the IPSASB finalised a revised standard on borrowing costs and the AASB had considered its suitability in an Australian context in light of the outcome of the FRSB/AASB DRC work and the draft Process.

IPSASB project to revise IPSAS 5 Borrowing Costs – 2009

IPSAS 5 *Borrowing Costs* is the international public sector equivalent of IAS 23. When it was first issued it adopted the same approach as the original IAS 23 and permitted capitalisation or expensing of borrowing costs.

Following the IASB's revision of IAS 23, IPSASB issued ED 35 *Borrowing Costs* which proposed to amend IPSAS 5. ED 35 however did not propose to mandate the capitalisation of borrowing costs. Instead, it proposed the expensing of borrowing costs with capitalisation being permitted in limited circumstances.

Responses on ED 35 were mixed and, despite seeking further feedback from respondents regarding the rationale for views held, the IPSASB was unable to come to a timely decision. The IPSASB has deferred this issue for consideration in the context of the Measurement phase of its Conceptual Framework project.

Appendix B: PBE/NFP exemptions in AASB 123/NZ IAS 23 Borrowing Costs

The current exemptions in AASB 123/NZ IAS 23 are set out below.

AASB 123	NZ IAS 23
8 An entity shall 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. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.	**8 An entity shall 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. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.**
Aus8.1 A not-for-profit 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.	
Aus8.2 In respect of not-for-profit public sector entities, paragraphs 9-26, 27 and 28 apply only when an entity elects 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.	
9 Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. When an entity applies AASB 129 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with paragraph 21 of that Standard.	9 Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. When an entity applies NZ IAS 29 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with paragraph 21 of that Standard.
	29 An entity shall apply the Standard for annual periods beginning on or after 1 January 2009. Earlier application is permitted only when an entity complies, or has complied, with New Zealand Equivalent to IFRS 1 *First-time Adoption of New Zealand Equivalents to International Financial Reporting Standards* for an annual period beginning on or after 1 January 2005. If an entity applies the Standard for an annual period beginning before 1 January 2009, it shall disclose that fact.
	Public Benefit Entities NZ 29.1 Notwithstanding paragraph 29 of this Standard, public benefit entities are permitted, but not required, to apply this Standard for annual periods beginning on or after 1 January 2009[2]. Earlier application is permitted in accordance with paragraph 29 of this Standard. A public benefit entity that elects to defer the application of NZ IAS 23 (revised 2008) shall expense borrowing costs in accordance with NZ IAS 23 (2004), shall disclose that fact and shall apply the related consequential amendments to NZ IAS 16 *Property, Plant and Equipment* and NZ IAS 11 *Construction Contracts*.

[2] In October 2008, the FRSB agreed to defer the application of NZ IAS 23 by public benefit entities. The FRSB currently has a project on the application of NZ IAS 23 to public benefit entities.