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A guide to IFRS reporting

Volume A, Part 1

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Introduction

1 Scope and objectives of this manual

The objective of this manual is to introduce and explain the financial reporting requirements under International Financial Reporting Standards (IFRSs). As explained in **section 3** below, IFRSs are defined to include the numbered IFRSs issued by the International Accounting Standards Board (IASB), International Accounting Standards (IASs) originally issued by its predecessor body (as amended) and approved Interpretations of these Standards. The expression is used in this broad sense in this manual unless the context requires otherwise.

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2 Structure of this manual

The structure of this manual is as follows:

- **chapter A1** provides background information on the IASB and on the application of IFRSs globally;
- **chapters A2** to **A41** and **appendices A1** to **A3** deal with the framework and Standards issued by the IASB and Interpretations of those Standards, and **appendix A4** deals with the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs);
- Volume B deals with accounting for financial instruments for entities that have adopted IFRS 9 *Financial Instruments*. It covers IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* (as amended by IFRS 9), IFRS 7 *Financial Instruments: Disclosures* and IFRS 9; and
- Volume C deals with accounting for financial instruments for entities that have not yet adopted IFRS 9. It covers IAS 32, IAS 39 (prior to amendment by IFRS 9), and IFRS 7.

Transitional requirements are discussed for Standards that have become effective for periods beginning after 1 January 2010. In addition, when IFRS 1 *First-time Adoption of International Financial Reporting Standards* requires compliance with the transitional requirements in Standards, the relevant requirements are explained.

2015, and 2) if a decision is taken to move to mandatory application of IFRSs, there will be a five-to-seven-year preparation period. The timing for the final decisions has not yet been set.

IFRSs are looked to in developing national GAAP to varying degrees in China, Indonesia, Thailand and Vietnam, but significant differences exist.

4.6 Use of IFRSs in other parts of the world

Many countries in the rest of the world are either already requiring or permitting IFRSs or are in the process of moving to IFRSs. South African listed companies must use IFRSs, and many of the former Soviet Union countries have adopted (in part or comprehensively) IFRSs as their primary accounting framework. For a detailed country-by-country list of the status of adoption of IFRSs, see *www.iasplus.com*.

5 IFRS for Small and Medium-sized Entities

In July 2009, the IASB issued the IFRS for Small and Medium-sized Entities (SMEs). It is a self-contained Standard of about 230 pages tailored for the needs and capabilities of smaller businesses. Many of the principles in full IFRSs for recognising and measuring assets, liabilities, income, and expenses have been simplified; topics not relevant to SMEs have been omitted; and the number of required disclosures has been significantly reduced. To lessen the reporting burden for SMEs further, revisions to the IFRS for SMEs will be limited to once every three years. It was effective immediately on issue.

The IFRS for SMEs is separate from full IFRSs and is therefore available for any jurisdiction to adopt whether or not it has adopted full IFRSs. It is also for each jurisdiction to determine which entities should use the Standard.

See **appendix A4** for an overview of the IFRS for SMEs.

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A2 Conceptual framework for financial reporting

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1 Introduction

In September 2010, the IASB and the US FASB completed the first phase of their joint project to develop an improved and converged conceptual framework for IFRSs and US GAAP. At that time, they issued two chapters of the *Conceptual Framework for Financial Reporting* (the Conceptual Framework) – Chapter 1 *The objective of general purpose financial reporting* and Chapter 3 *Qualitative characteristics of useful financial information*.

The Conceptual Framework project is being carried out in phases (see **section 9**). As each phase is finalised, the relevant paragraphs in the *Framework for the Preparation and Presentation of Financial Statements* (the IASB's predecessor framework) are replaced.

This chapter follows the text of the *Conceptual Framework for Financial Reporting* in the IASB's 2011 Bound Volume. It incorporates the two chapters of the Conceptual Framework completed in September 2010, with the remaining text (**sections 6** to **8** below) carried forward from the predecessor framework pending completion of the remaining phases.

The Conceptual Framework sets out the concepts underlying the preparation and presentation of financial statements for external users. A comprehensive discussion of each of the topics covered in the Conceptual Framework is beyond the scope of this text. The following sections therefore provide a very brief summary of the matters discussed therein.

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1.1 Terminology

When the IASB revised IAS 1 *Presentation of Financial Statements* in 2007, it did not amend the terminology used in the *Framework for the Preparation and Presentation of Financial Statements*, and this pre-2007 terminology is carried forward to the Conceptual Framework. Accordingly, the Conceptual Framework still refers, for example, to the 'balance sheet', rather than to the 'statement of financial position'.

2 Purpose and status of the Conceptual Framework

The purpose of the Conceptual Framework is:

- to assist the IASB in the development of future IFRSs and in its review of existing IFRSs;

- to assist the IASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;
- to assist national standard-setting bodies in developing national standards;
- to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
- to assist auditors in forming an opinion as to whether financial statements comply with IFRSs;
- to assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IFRSs; and
- to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.

The Conceptual Framework is not itself an International Financial Reporting Standard and, therefore, it does not define standards for particular recognition, measurement, presentation or disclosure issues. There may be conflicts between the Conceptual Framework and individual Standards or Interpretations, which are being addressed by the IASB over time. When such a conflict arises, the Standard or Interpretation takes precedence. This is a key point in that it clarifies that the principles of the Conceptual Framework cannot be used to justify a treatment that contravenes an extant IFRS.

Some of the older Standards depart from the Conceptual Framework in that they:

- recognise assets or liabilities that do not meet the Conceptual Framework definitions (e.g. actuarial gains and losses deferred under IAS 19 *Employee Benefits* prior to its revision in June 2011 – see **appendix A3**); or
- measure assets or liabilities on bases other than those specified in the Conceptual Framework (e.g. government grants recognised at a nominal amount under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* – see **chapter A36**).

As noted above, when there is conflict between an IFRS and the Conceptual Framework, the IFRS prevails.

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In the absence of a Standard or an Interpretation that specifically applies to a transaction or event, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that management should use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, IAS 8:11 requires management to consider first the requirements and guidance in Standards and Interpretations dealing with similar and related issues, and second the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Conceptual Framework (see **section 3.1** of **chapter A5**).

3 Scope

The Conceptual Framework deals specifically with:

- the objective of general purpose financial reporting (see **section 4** below);
- the qualitative characteristics of useful financial information (see **section 5** below);
- the definition, recognition and measurement of the elements from which financial statements are constructed (see **sections 6** and **7** below); and
- concepts of capital and capital maintenance (see **section 8** below).

The Conceptual Framework is not directly relevant for entities applying the *IFRS for SMEs*, which includes a section setting out its underlying concepts and pervasive principles.

4 The objective of general purpose financial reporting

Chapter 1 of the Conceptual Framework addresses the objective of general purpose financial reporting (hereafter, just 'financial reporting') – which is considered to be the foundation of the Conceptual Framework from which the other aspects (to be dealt with in later chapters) flow logically.

The objective of financial reporting is identified as being "to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit". [CF:OB2]

The primary users of general purpose financial reports are identified as existing and potential investors, lenders and other creditors who cannot require the entity to provide information directly to them and who, consequently, rely on general purpose financial reports for much (but not all) of the financial information they need. [CF:OB5] Other parties (e.g. regulators and members of the public) may make use of general purpose financial reports but the information included therein is not primarily directed to such parties. [CF:OB10]

The needs of all of the primary users are not the same – and the Conceptual Framework establishes the principle that, in developing IFRSs, the IASB "will seek to provide the information set that will meet the needs of the maximum number of primary users". [CF:OB8]

Information is considered to be 'useful' if it helps the primary users of general purpose financial reports to assess the prospects for future net cash inflows to an entity; such an assessment enables the primary users to estimate the return that they can expect from transacting with the entity. [CF:OB3]

To assess an entity's prospects for future net cash inflows, the primary users need information regarding (1) the resources of the entity and claims against the entity, and (2) how efficiently and effectively the entity's management has discharged its responsibilities. [CF:OB4]

The responsibilities referred to in CF:OB4 are generally referred to as management's 'stewardship' responsibilities. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions.

This subject sparked considerable debate during the development of Chapter 1 of the Conceptual Framework. While 'stewardship' is not a separate objective of financial reporting in the final chapter as some had requested, the IASB has acknowledged that evaluating past performance of an entity is as important as predicting future cash flows.

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4.1 Information about the resources of the entity and claims against the entity

General purpose financial reports provide information about: [CF:OB12 & OB15]

- the financial position of an entity (i.e. information about its economic resources and claims against it);

- the financial performance of an entity; and
- the effects of other events and transactions that affect the entity's economic resources and claims against it (e.g. issuing debt or equity securities).

Although the Conceptual Framework refers to financial performance, it does not define it. However, it appears clear that financial performance does not reflect all changes in the financial position of an entity in that it excludes changes that relate to contributions from and distributions to equity participants (see the discussion in section 7 below).

Information about the nature and amounts of an entity's economic resources and claims against it is useful for assessing its financial strengths and weaknesses, such as the liquidity of the entity and its financing needs. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the entity. [CF:OB13]

Information about the performance of an entity helps users to understand the return that the entity has produced from its economic resources (which is an indication of how well management has discharged its stewardship responsibilities). Information regarding the performance of an entity is prepared using the accrual basis of accounting (i.e. focusing on the effects of events and transactions when they occur and not necessarily when cash is received or paid), which is considered to provide a better basis for assessing the entity's past and future performance than information solely about cash receipt and payments. [CF:OB16 & 17]

Information about an entity's cash flows during a period is also considered to be useful in the assessment of the entity's ability to generate future net cash inflows; it helps users to understand an entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance. [CF:OB20]

Finally, information regarding changes in the entity's resources and claims against it for reasons other than financial performance (e.g. the issue of additional ownership shares) is needed to provide users of general purpose financial reports with a complete understanding of why the entity's economic resources and claims against it have changed and the implications of those changes for its future financial performance. [CF:OB21]

5 Qualitative characteristics of useful financial statements

Chapter 3 of the Conceptual Framework considers the qualitative characteristics of decision-useful financial information, and constraints on the information that can be provided by financial reporting, so as to identify the types of information that are likely to be most useful to the primary users of general purpose financial reports.

The Conceptual Framework states that if financial information is to be useful, it must be relevant and faithfully represent what it purports to represent; these are the two fundamental qualitative characteristics of useful financial information – 'relevance' and 'faithful representation'. [CF:QC4 & 5] Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions. [CF:QC17]

The usefulness of financial information is considered to be enhanced if it is comparable, verifiable, timely and understandable. [CF:QC5] 'Comparability', 'verifiability', 'timeliness' and 'understandability' are therefore described as enhancing qualitative characteristics. [CF:QC19] The Conceptual Framework notes that such enhancement should be maximised to the extent possible. However, these qualitative characteristics cannot make information useful if the information is irrelevant or not faithfully represented. [CF:QC33]

Apart from changes in terminology and emphasis, the most notable differences between the qualitative characteristics described in the Framework for the Preparation and Presentation of Financial Statements (the IASB's predecessor framework) and the Conceptual Framework are the omission of any discussion of 'substance over form' and 'prudence'. These omissions are discussed in the Basis for Conclusions on the Conceptual Framework.

The Board determined that 'substance over form' should not be presented as a separate component of faithful representation because it would be redundant. Faithful representation means that financial information presents the substance of events and transactions rather than merely their legal form. Representing a legal form that differs from the economic substance of the underlying economic event or transaction could not result in a faithful representation. [CF:BC3.26] Therefore, although not specifically referred to in the Conceptual Framework, the concept of 'substance over form' continues to be relevant (see section 3.1 of chapter A4 for further discussion).

No reference is made to prudence (or conservatism) as an aspect of faithful representation because the Board considered that including either would be inconsistent with neutrality. The Board concluded that, even with the prohibitions against deliberate misstatement that appear elsewhere, an admonition to be prudent would be likely to lead to a bias. [CF:BC3.27 – 29]

5.1 Fundamental qualitative characteristics

5.1.1 Relevance

Financial information is relevant when it is "capable of making a difference in the decisions made by users". [CF:QC6] Information is capable of making a difference in a decision-making process if it has predictive value (i.e. it can be used as an input to predict future outcomes), confirmatory value (i.e. it provides feedback about previous evaluations) or both.

In determining whether or not information is relevant to the needs of users, preparers of financial information need to take account of the nature and materiality of the information. Information is considered to be material if omitting it or misstating it could influence the decisions of users taken on the basis of the financial information. Because materiality is an entity-specific characteristic to be determined in the context of an individual entity's financial report, the IASB has concluded that it cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation. [CF:QC11]

5.1.2 Faithful representation

Relevant financial information must also be faithfully represented to be useful. A faithful representation is one that is "complete, neutral, and free from error" to the extent possible.
[CF:QC12 – QC15]

- A depiction is 'complete' if it includes all of the information that a user needs to understand what is being reported, including all necessary descriptions and explanations.
- A depiction is 'neutral' if it is without bias in the selection or presentation of financial information (i.e. it is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users).
- A depiction is 'free from error' if there are no errors or omissions in the information provided and the process used to produce the

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reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects.

5.2 Enhancing qualitative characteristics

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics may also help determine which of two ways should be used to depict an event or transaction if both are considered equally relevant and faithfully represented. [CF:QC19]

5.2.1 *Comparability*

Information about an entity is considered to be more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. [CF:QC20 & 21]

Using the same methods for the same items, either from period to period within an entity or in a single period across entities (i.e. consistency), helps to achieve comparability. [CF:QC22]. Although an economic event or transaction can sometimes be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability. [CF:QC25]

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5.2.2 *Verifiability*

Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable – a range of possible amounts and the related probabilities can also be verified. Verifiability helps assure users that information faithfully represents the events or transactions it purports to represent. [CF:QC26]

Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation (e.g. by counting cash). Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. [CF:QC27]

It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it would normally be necessary to disclose the underlying assumptions, the methods of compiling the information and other factors and circumstances that support the information. [CF:QC28]

5.2.3 *Timeliness*

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends. [CF:QC29]

5.2.4 *Understandability*

Classifying, characterising and presenting information clearly and concisely makes it understandable. [CF:QC30]

The Conceptual Framework allows a preparer to assume that users have a reasonable knowledge of business and economic activities, and that users review and analyse the information diligently. Complex financial information should not be excluded from financial reports in order to make those financial reports easier to understand, because the resulting information would be incomplete and, therefore, potentially misleading. [CF:QC31 & 32]

5.3 The cost constraint on financial reporting

The Conceptual Framework acknowledges that cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. [CF:QC35]

Costs are incurred by providers of financial information in collecting, processing, verifying and disseminating financial information; users of financial information also incur costs when analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it. [CF:QC36]

In applying the cost constraint when developing IFRSs, the IASB assesses whether the benefits of reporting particular information are likely to

justify the costs incurred to provide and use that information. The Board seeks to consider costs and benefits in relation to financial reporting generally and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs or other factors. [CF:QC38 & 39]

6 Assumptions underlying the preparation of financial statements

Chapter 4 of the Conceptual Framework identifies 'going concern' as one assumption underlying the preparation of financial statements. This assumption (together with a number of other general features of financial statements introduced in IAS 1 *Presentation of Financial Statements*) is discussed in **chapter A4**.

7 The elements of financial statements

Chapter 4 of the Conceptual Framework (carried forward from the IASB's predecessor framework) provides definitions for the elements of financial statements, as well as principles for the recognition and measurement of those elements.

7.1 Assets

7.1.1 Definition

The Conceptual Framework defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [CF:4.4(a)]

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents. [CF:4.8] Such benefits may flow to the entity in a number of ways – e.g. by use in the production process, by exchange for other assets, as settlement of a liability, or by distribution to the owners of the entity.

Many assets have physical form – but that is not essential to the existence of an asset. For example, intangibles such as patents and copyrights are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity. [CF:4.11]

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The entity's control over those future economic benefits will most commonly be evidenced by legal ownership, but that is not essential. For example, property held on lease is an asset if the entity controls the benefits that are expected to flow from it. [CF:4.12]

The entity will usually have legal rights over an asset – but not necessarily so. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping the know-how secret, an entity controls the benefits that are expected to flow from it. [CF:4.12]

The assets of an entity must result from a past transaction or event. Assets are most usually acquired by purchasing or producing them – but this will not always be the case (e.g. when assets may be received by way of government grant or contributions from equity participants). [CF:4.13]

There is a 'close association' between incurring expenditure and generating assets, but the two do not necessarily coincide. An entity may incur expenditure with a view to obtaining future economic benefits, but the expenditure may not result in an item satisfying the definition of an asset. Equally, an item may satisfy the definition of an asset without any expenditure having been incurred (e.g. a donated asset). [CF:4.14]

7.1.2 Recognition

An asset should be recognised in the balance sheet when: [CF:4.44]

- it is probable that the future economic benefits will flow to the entity; and
- the asset has a cost or value that can be measured reliably.

The assessment of the degree of uncertainty attaching to the flow of future economic benefits is made on the basis of the evidence available when the financial statements are prepared. An asset is not recognised in the balance sheet when expenditure has been incurred from which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction is dealt with as an expense in the income statement.

7.1.3 Measurement

The determination of the monetary amount at which an asset is to be recognised in the balance sheet involves the selection of a particular basis of measurement.

The most common bases of measurement for assets are:
[CF:4.55]

- historical cost – assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition;
- current cost – assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently;
- realisable value – assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal; and
- present value – assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

The Conceptual Framework does not indicate a preference for any of these measurement bases. It points out that the measurement basis most commonly adopted is historical cost – often combined with other bases. For example, inventories are usually carried at the lower of cost and net realisable value. [CF:4.56]

7.2 Liabilities

7.2.1 *Definition*

The Conceptual Framework defines a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. [CF:4.4(b)]

An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable (e.g. a binding contract or a statutory requirement). Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or to act in an equitable manner. For example, an entity may decide as a matter of policy to rectify faults in its products after the warranty period has expired, even though it has no legal obligation to do so, with the objective of maintaining its reputation with customers. [CF:4.15]

The Conceptual Framework draws a distinction between a present obligation and a future commitment. A decision by management to acquire an

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asset or to incur expenditure in the future does not, of itself, create a present obligation. An obligation normally arises only when the goods are delivered or an irrevocable agreement is entered into. [CF:4.16]

The settlement of a liability usually involves the entity giving up resources embodying economic benefits – whether by payment of cash, transfer of other assets, provision of services, replacement of the obligation by another obligation, or conversion of the obligation to equity. [CF:4.17]

7.2.2 *Recognition*

A liability should be recognised in the balance sheet when:
[CF:4.46]

- it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation; and
- the amount at which the settlement will take place can be measured reliably.

In practice, obligations under contracts that are equally proportionately unperformed (e.g. liabilities for inventories ordered but not yet received) are generally not recognised as liabilities in the financial statements (see **chapter A12** for a discussion of executory contracts).

7.2.3 *Measurement*

The determination of the monetary amount at which a liability is to be recognised in the balance sheet involves the selection of a particular basis of measurement.

The most common bases of measurement for liabilities are:
[CF:4.55]

- historical cost – liabilities are recorded at the amount of the proceeds received in exchange for the obligation or at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business;
- current cost – liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently;
- settlement value – liabilities are carried at their settlement values, i.e. at the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business; and

An expense is recognised immediately in the income statement in those cases when the expenditure produces no future economic benefits, or when future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset. [CF:4.52]

An expense is also recognised in the income statement when a liability is incurred without the recognition of an asset, e.g. when a liability arises under a product warranty. [CF:4.53]

7.6 Transactions with equity participants

The definitions of both income and expenses set out in the previous sections exclude contributions from and distributions to equity participants. These exclusions are based on the principle that profit or loss of the entity cannot be created simply by transferring resources to or from the owners of the entity.

8 Concepts of capital and capital maintenance

The Conceptual Framework identifies two concepts of capital maintenance:
[CF:4.59]

- financial capital maintenance – under which profit is earned only if the financial (or money) amount of the net assets at the end of the reporting period exceeds the financial (or money) amount of net assets at the beginning of the reporting period, after excluding any distributions to, and contributions from, owners during the period; and
- physical capital maintenance – under which a profit is earned only if the physical productive capacity (or operating capability) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

The Conceptual Framework does not indicate a preference for either of these concepts of capital maintenance.

The selection of a concept of capital maintenance (and of the measurement basis to be used) determines the accounting model used in preparation of the financial statements. The Conceptual Framework acknowledges that

different accounting models exhibit different degrees of relevance and reliability, and that preparers of financial statements should seek a balance between those characteristics.

9 Future developments

At the time of writing, the IASB and the FASB have completed Phase A in their joint project to develop a common conceptual framework (comprising 2 chapters – see **section 1** above). The remaining stages in the project are listed below.

Phase B: Definitions of elements, recognition and derecognition

Phase C: Measurement

Phase D: Reporting entity concept

Phase E: Boundaries of financial reporting, and presentation and disclosure

Phase F: Purpose and status of the framework

Phase G: Application of the framework to not-for-profit entities

Phase H: Remaining issues, if necessary

In March 2010, an exposure draft of the reporting entity chapter (Phase D) was published, with comments to be submitted by 16 July 2010. The IASB and the FASB have had some follow-up discussions on the responses to the exposure draft, and preliminary discussions on Phases B and C, but further progress has been limited by the priority given to other projects since mid-2010.

In July 2011, the IASB published a request for views to consult on its agenda; after that consultation is complete, the Board will decide whether and how to continue with the common conceptual framework project.

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A18 Borrowing costs

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1 Introduction

IAS 23 *Borrowing Costs* prescribes the accounting treatment for borrowing costs.

The Standard was significantly revised in March 2007, when the option to expense all borrowing costs (including those directly attributable to the acquisition, construction or production of qualifying assets) was removed with effect for annual periods beginning on or after 1 January 2009. The Standard was most recently amended in May 2008 by *Improvements to IFRSs*.

2 Core principle and scope

The core principle of IAS 23 is that borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense. [IAS 23:1]

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Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. [IAS 23:5]

Borrowing costs may include:
[IAS 23:6]

- interest expense calculated using the effective interest method as described in IAS 39 *Financial Instruments: Recognition and Measurement*;
- finance charges in respect of finance leases recognised in accordance with IAS 17 *Leases*; and
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. [IAS 39:9] See **section 4.1** of **chapter C6** (or, for entities that have adopted IFRS 9, **section 4.1** of **chapter B6**) for further discussion.

An entity is not required to apply IAS 23 to borrowing costs directly attributable to the acquisition, construction or production of:
[IAS 23:4]

(a) a qualifying asset (see **3.1** below) measured at fair value (e.g. a biological asset or an investment property under construction measured at fair value); or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

The exemption for assets measured at fair value recognises that the measurement of such assets is not affected by the amount of borrowing costs incurred during their construction or production period. The exemption for inventories manufactured in large quantities on a repetitive basis acknowledges the difficulty both in allocating borrowing costs to such inventories and monitoring those borrowing costs until the inventory is sold. The IASB concluded that it should not require entities to capitalise borrowing costs on such inventories because the costs of capitalisation were likely to exceed the potential benefits.

These exemptions are optional rather than mandatory. Accordingly, an entity can choose, as a matter of accounting policy, whether to apply the requirements of IAS 23 to borrowing costs that relate to assets measured at fair value and / or inventories produced in large quantities on a repetitive basis.

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2.1 Exchange differences to be included in borrowing costs

IAS 23 includes no further clarification as to what is meant by the inclusion of exchange differences 'to the extent that they are regarded as an adjustment to interest costs'. The question has been addressed by the IFRIC (now the IFRS Interpretations Committee) but not added to its agenda (see *IFRIC Update*, January 2008). The IFRIC reaffirmed that how an entity applies IAS 23 to foreign currency borrowings is a matter of accounting policy requiring the exercise of judgement. When the accounting policy adopted is relevant to an understanding of the financial statements, it should be disclosed as required by IAS 1 *Presentation of Financial Statements*.

It is clear that not all exchange differences arising from foreign currency borrowings can be regarded as an adjustment to interest

costs; otherwise, there would be no requirement for the qualifying terminology used in IAS 23:6(e). The extent to which exchange differences can be so considered depends on the terms and conditions of the foreign currency borrowing.

Qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred, should be classified as borrowing costs. Although exchange rate fluctuations may mean that this amount is substantially higher or lower than the interest costs contemplated when the original financing decision was made, the full amount is appropriately treated as borrowing costs.

Some exchange differences relating to the principal may be regarded as an adjustment to interest costs (and, therefore, taken into account in determining the amount of borrowing costs capitalised) but only to the extent that the adjustment does not decrease or increase the interest costs to an amount below or above a notional borrowing cost based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing. In other words, the amount of borrowing costs that may be capitalised should lie between the following two amounts:

(1) actual interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred; and

(2) notional borrowing costs based on commercial interest rates prevailing in the functional currency at the date of initial recognition of the borrowing.

Whether any adjustments for exchange differences are made to the amount determined under (1) above is an accounting policy choice and should be applied consistently.

The extent to which foreign exchange losses can be regarded as borrowing costs is illustrated in **example 2.1A** and **example 2.1B** below.

Example 2.1A

Exchange differences increase borrowing costs

Entity X, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

[illegible]

If the retranslation of the US$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange gain, the entire gain should be recognised in profit or loss. The amount of capitalised borrowing costs would be Thailand Baht 216 million (interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, because any such adjustment would result in an amount of borrowing costs outside the acceptable range of amounts.

Example 2.1B

Exchange differences decrease borrowing costs

Entity Y, which prepares its financial statements in its functional currency of Thailand Baht (THB), enters into a borrowing arrangement with terms and conditions as set out below.

Borrowed amount (in the foreign currency)	US$100 million
Date of initial recognition of the borrowing	1 January 20X1
Exchange rate at the date of initial recognition of the borrowing	THB25:US$1
Interest rate on foreign borrowings (in US$)	6% per annum (fixed)
Interest rate on similar borrowing in THB as at the date of initial recognition of the borrowing	8% per annum (fixed)
Average exchange rate for 20X1	THB36:US$1
Closing exchange rate for 20X1	THB22:US$1

The following interest payments were made in 20X1.

Interest payments (6% x US$100 million)	US$6 million
Translated at average rate	THB216 million

Entity Y should capitalise THB216 million, being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred.

In addition, Entity Y may choose as its accounting policy to regard exchange differences as an adjustment to interest costs. If it does so, in order to determine the maximum potential adjustment to interest costs for exchange differences, Entity Y should determine the borrowing costs that would have been incurred in the 20X1 reporting period if the funds had been borrowed in THB. The calculation is set out below.

THB equivalent of US$100 million at 1 January 20X1	THB2,500 million
Annual interest expense based on THB interest rates (8%)	THB200 million

In the circumstances described, the notional borrowing cost in the entity's functional currency of THB 200 million is the 'floor' on the amount to be classified as borrowing costs. Consequently, when it has made the relevant accounting policy choice, Entity Y should capitalise an amount of borrowing costs between THB200 million and THB216 million.

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The foreign exchange gain incurred on the retranslation of the principal amount of the US$100 million borrowings at the end of the 20X1 reporting period is calculated as follows.

THB equivalent at opening rate of THB25:US$1	THB2,500 million
THB equivalent at closing rate of THB22:US$1	THB2,200 million
Foreign exchange gain	THB300 million

As calculated above, the 'floor' on the amount to be classified as borrowing costs in the 20X1 accounting period is THB200 million. The difference of THB16 million between this amount and THB216 million (being the qualifying interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred) is the amount of the foreign exchange gain on the principal to be offset in borrowing costs. The remaining exchange gain on the principal (THB284 million) is recognised in profit or loss in the year.

If the retranslation of the US$100 million at the end of the 20X1 reporting period gave rise to a foreign exchange loss, the entire loss should be recognised in profit or loss. The amount of capitalised borrowing costs would be THB216 million (interest costs denominated in the foreign currency, translated at the actual exchange rate on the date on which the expense is incurred). No adjustment to interest costs for exchange differences should be made, as any such adjustment would result in an amount of borrowing costs outside the acceptable range of amounts.

2.2 Costs associated with shares and similar instruments classified as financial liabilities

IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability. [IAS 23:3]

By implication, IAS 23 does apply to costs associated with shares and similar financial instruments that are classified as liabilities, in accordance with the requirements of IAS 32 *Financial Instruments: Presentation*. Under IAS 32:35, the dividends paid on such instruments are recognised in profit or loss as an expense. IAS 32:36 states that "dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond".

Although IAS 23 does not define what is meant by "the borrowing of funds", the classification of shares and similar instruments as liabilities means that they should be considered to represent such borrowings. As a result, the costs of servicing those shares (e.g. dividends) fall within the definition of borrowing costs.

2.3 Imputed interest on convertible debt instruments

In accordance with IAS 32 *Financial Instruments: Presentation*, the liability component of a convertible debt instrument is presented on an amortised cost basis using the coupon rate for an equivalent non-convertible debt. The imputed interest is recognised in profit or loss using IAS 39's effective interest method. Therefore, it is appropriate for the imputed interest expense in relation to the liability component of the convertible debt instrument to be included in borrowing costs eligible for capitalisation.

3 Recognition of borrowing costs

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are capitalised as part of the cost of the qualifying asset. Other borrowing costs are recognised as an expense in the period in which they are incurred. [IAS 23:8 & 9]

Before its revision in 2007, IAS 23 allowed an accounting policy of expensing all borrowing costs. **Section 5** deals with the transition provisions for an entity that previously had such a policy.

When an entity applies 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 IAS 29:21 (see **5.1.4** in **chapter A37**). [IAS 23:9]

3.1 Qualifying assets

A qualifying asset is defined as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. [IAS 23:5]

The Standard does not provide any guidance on what constitutes a 'substantial period of time'. The specific facts and circumstances should be considered in each case. For example, it is likely that a period of twelve months or more might be considered 'substantial'.

Depending on the circumstances, any of the following may be qualifying assets:
[IAS 23:7]

- inventories;

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- intangible assets;
- investment properties;
- manufacturing plants; and
- power generation facilities.

The following are *not* qualifying assets:
[IAS 23:7]

- assets that are ready for their intended use or sale when acquired;
- financial assets; and
- inventories that are manufactured, or otherwise produced, over a short period of time.

3.1.1 Assets with an extended delivery period

IAS 16 *Property, Plant and Equipment* identifies delivery and handling costs as part of the cost of an item of property, plant and equipment. It includes such activities as part of the process of preparing the asset for its intended use. The shipping of an asset is therefore part of its acquisition and, consequently, borrowing costs attributable to the shipping period can be considered to be borrowing costs directly attributable to the acquisition of the asset as required by IAS 23.

For example, an entity orders and pays for a large piece of equipment from overseas that will take six months (in this example judged to be a 'substantial' period of time for the purposes of IAS 23) to arrive. A loan is raised to finance the acquisition. The equipment is already manufactured and available for shipment. Therefore, the period between payment for the equipment and its installation is only caused by shipping time. The asset is recognised by the entity on the date of shipping by the supplier because (in this example) that is the date on which the risks pass to the entity. Borrowing costs incurred on the loan raised to finance the acquisition will be capitalised as part of the cost of the equipment up to the date that the asset arrives at its destination, is installed and is ready for its intended use.

3.1.2 Equity method investments

Example 3.1.2

Determining whether an equity method investment can be a qualifying asset

Company X invests in construction contracts via participating interests in single-purpose entities. The entities are associates (as defined in IAS 28) and are accounted for using the equity method of accounting. If Company X borrows funds for the purpose of funding the construction activities in these equity method vehicles, should it capitalise borrowing costs as part of the carrying amount of the equity method investments?

No. Borrowing costs should not be capitalised in these circumstances. Investments in associates are financial assets. IAS 23:7 states that financial assets are not qualifying assets.

It is sometimes argued, when a vehicle is established for the purpose of constructing a qualifying asset, that the substance of the arrangement is that the investment is itself a qualifying asset for the investor. The logic is most appealing in the case of projects organised by a limited number of investors to pool resources in developing production facilities or properties. It is argued that, from the investor's perspective, the amount of borrowing costs capitalised should not be different simply because construction of the qualifying asset is through a separate investee vehicle, rather than by the investing entity itself.

However, the accounting for the investor's interest in the vehicle will determine whether or not there is a qualifying asset. If the vehicle is accounted for using the equity method, the interest is a financial asset, and capitalisation of borrowing costs is not permitted by IAS 23. Therefore, capitalisation of borrowing costs is not permitted either (1) for entities that have adopted IFRS 11, in respect of assets held via joint ventures, or (2) for entities that have not yet adopted IFRS 11, in respect of assets held via jointly controlled entities that are accounted for using the equity method under IAS 31's allowed alternative treatment.

In contrast:

- for entities that have adopted IFRS 11 *Joint Arrangements*, if the interest meets the definition of a joint operation, the entity will instead recognise its share of the assets and liabilities, and capitalisation of borrowing costs will be required to the extent that any of the assets are qualifying assets (see **3.1.3**); and
- for entities that have not yet adopted IFRS 11 *Joint Arrangements*, when a jointly controlled entity is accounted for using proportionate consolidation under IAS 31's benchmark treatment, capitalisation of borrowing costs is required to the extent that any of the assets are qualifying assets (see **3.1.4**).

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3.1.3 *Joint operations (entities that have adopted IFRS 11)*

In contrast to the prohibition on capitalisation of borrowing costs in respect of equity method investments as described in **example 3.1.2**, when an entity recognises its share of the assets and liabilities of a joint operation, capitalisation of borrowing costs is required to the extent that any of those assets are qualifying assets.

The investor's share of the qualifying assets of a joint operation are accounted for as qualifying assets of the investor and, therefore, capitalisation of borrowing costs incurred to fund the construction of those qualifying assets is required, provided that all of the conditions of IAS 23 are met.

3.1.4 *Jointly controlled entities accounted for using proportionate consolidation (entities that have not yet adopted IFRS 11)*

In contrast to the prohibition on capitalisation of borrowing costs in respect of equity method investments as described in **example 3.1.2**, when a jointly controlled entity is accounted for using proportionate consolidation under IAS 31's benchmark treatment, capitalisation of borrowing costs is required.

The investor's share of the qualifying assets of a jointly controlled entity accounted for using proportionate consolidation can be considered to be qualifying assets for the purposes of the consolidated financial statements and, therefore, capitalisation of borrowing costs incurred by any group entity to fund the construction of those qualifying assets is required, provided that all of the conditions of IAS 23 are met.

3.2 Borrowing costs eligible for capitalisation

The borrowing costs that are eligible for capitalisation are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. [IAS 23:10]

IFRIC 1:8 makes clear that capitalisation is not permitted for the periodic unwinding of the discount in relation to changes in obligations to dismantle, remove and restore items of property, plant and

equipment. Instead, the periodic unwinding of the discount is recognised in profit or loss as a finance cost as it occurs.

The definition of borrowing costs does not specifically mention gains or losses arising on early termination or early repayment of borrowed funds. However, such gains and losses would appear not to be directly attributable to the acquisition, construction or production of a qualifying asset, but rather to a change in how an entity chooses to finance itself. Accordingly, it seems appropriate for gains or losses arising on early termination or early repayment of borrowed funds to be recognised in profit or loss, rather than being capitalised as part of the cost of a qualifying asset.

3.2.1 *Specific borrowing costs*

When funds are borrowed specifically for the purpose of acquiring or constructing a qualifying asset, the amount of borrowing costs eligible for capitalisation is the actual borrowing costs incurred on those funds during the period. [IAS 23:12]

The financing arrangements may result in the specific borrowings being drawn down prior to some or all of the funds being utilised to finance the qualifying asset. In such circumstances, any investment income earned on the temporary investment of the funds, pending their expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation. [IAS 23:13]

Example 3.2.1

Specific borrowing costs offset by investment income on excess funds

An entity borrows CU20 million to finance the construction of a factory. The funds are to be drawn down on a monthly basis in four equal amounts. Payment of construction costs occurs throughout each month, rather than coinciding with the draw-downs. During each month, the entity invests any excess funds drawn down in accordance with the financing arrangements in short-term bank deposits.

In its financial statements for the year, the entity should capitalise, as part of the cost of construction of the factory, the actual borrowing costs on the CU20 million borrowing (incurred during the period of construction), less the interest income derived from the temporary investments in bank deposits.

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3.2.2 *General borrowing costs*

When a qualifying asset is funded from a pool of general borrowings, the amount of the borrowing costs eligible for capitalisation is not so obvious. While the basic principles still apply, there may be practical difficulties in identifying a direct relationship between the particular borrowings utilised and the qualifying assets.

3.2.2.1 *Calculation of capitalisation rate*

In these circumstances, IAS 23:14 requires that the amount of the borrowing costs to be capitalised should be determined by applying an appropriate capitalisation rate to the expenditure on the qualifying asset.

The capitalisation rate is calculated as follows:
[IAS 23:14]

$$\frac{\text{Total general borrowing costs for the period (i.e. excluding specific borrowings)}}{\text{Weighted average total general borrowings (i.e. excluding specific borrowings)}}$$

Example 3.2.2.1

Qualifying asset funded from a general borrowing pool

An entity centrally co-ordinates its financing activities through a treasury function, with borrowings being raised to finance general requirements, including the acquisition and development of qualifying assets.

During the year ended 31 December 20X1, the entity commenced a property development project and incurred the following expenditure:

	CU'000
1 June	5,000
1 October	10,000
1 November	10,000

The entity had total borrowings outstanding during the period, and incurred interest on those borrowings, as follows:

	Balance outstanding CU'000	Interest CU'000
Long-term loans*		
10 years at 10%	35,000	3,500
5 years at 8%	10,000	800
Short-term loans**	12,000	1,600
Bank overdraft*	5,000	500
	62,000	6,400

* There was no movement on long-term loans in the period.

** The amounts disclosed for short-term loans and the bank overdraft represent the average amounts outstanding during the period and the interest incurred at variable rates.

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

$$\frac{\text{Total borrowing costs for the period}}{\text{Weighted average total borrowings}} = \frac{6{,}400}{62{,}000} = 10.32\%$$

Interest capitalised is therefore calculated as follows:

	CU'000
CU5 million x 7/12 x 10.32%	301
CU10 million x 3/12 x 10.32%	258
CU10 million x 2/12 x 10.32%	172
Interest capitalised for the period	731

3.2.2.2 *Expenditure to which the capitalisation rate is applied*

The amount of expenditure on a qualifying asset used in the calculation should consist only of payments of cash, transfers of other assets or the assumption of interest-bearing liabilities, and should be reduced by any pre-sale deposits, progress payments or grants received in connection with the qualifying asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period. [IAS 23:18]

3.2.2.3 *Borrowing costs capitalised limited to the borrowing costs incurred*

The capitalisation of general borrowing costs calculated using the capitalisation rate is subject to the condition that the amount of borrowing costs capitalised should not exceed the actual borrowing costs incurred during that same period. [IAS 23:14]

Because the amount of borrowing costs capitalised may not exceed the amount of borrowing costs actually incurred, 'notional' interest expenses may not be capitalised. This point has particular relevance for groups with centralised banking arrangements whereby the 'banking' entity charges or credits interest to the other group entities in respect of its balances with those entities. Interest charged by one member of a group to another cannot be capitalised in the consolidated financial statements except to the extent that it represents an interest expense actually borne by the group on capital borrowed

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externally to finance the construction or production of the relevant asset. Intragroup interest is eliminated on consolidation.

Example 3.2.2.3

Borrowing costs capitalised limited to the borrowing costs incurred in a group context

A group consists of a parent, P, and two subsidiaries, S1 and S2. S1 is engaged in the construction of a power plant that is wholly financed by fellow subsidiary S2, which obtains the necessary funds through bank borrowings. No intragroup interest is charged by S2 to S1. The terms of the loan from S2 to S1 specify that it is repayable on demand.

In the circumstances described, no interest should be capitalised in either of the individual financial statements of S1 or S2. S1 has incurred no borrowing costs, and S2 has no qualifying asset.

However, it will be appropriate to capitalise interest in the consolidated financial statements of P, provided that the amount capitalised fairly reflects the interest cost to the group of borrowings from third parties which could have been avoided if the expenditure on the qualifying asset had not been made.

3.2.2.4 *Investment income on excess funds*

When funds are borrowed generally, interest income earned on excess funds should not be offset against the interest cost in determining the appropriate capitalisation rate, nor in determining the limit on capitalisation by reference to the amount of borrowing costs incurred during the period.

3.2.2.5 *Assets funded from specified cash balances*

When an entity has a general borrowing pool, it may nevertheless consider that expenditure on certain assets is met out of specified cash balances. In such circumstances, the question arises as to whether the entity is required under IAS 23:14 to capitalise 'deemed' borrowing costs in respect of the expenditure on such assets.

This question is not specifically dealt with in IAS 23. IAS 23:14 refers to "the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset". Therefore, it appears that to the extent that the asset is demonstrably not paid for out of

borrowings (e.g. it is paid for out of the cash proceeds of an equity issue), there is no requirement to capitalise a deemed interest cost.

To understand this position, contrast the IAS 23 requirements with those of US GAAP, which state that the interest cost to be capitalised is that which would theoretically have been avoided by using the funds expended to repay existing borrowings. Therefore, whenever an entity has a general borrowing pool, it is required to capitalise the borrowing costs that would have been avoided if the cash balances had been used to repay those borrowings.

Under IAS 23:14, there is no requirement to capitalise a 'deemed' interest cost, although it appears that adopting the approach required by US GAAP is also acceptable.

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3.2.2.6 *Use of insurance proceeds to fund the reconstruction of an asset*

Example 3.2.2.6

Use of insurance proceeds to fund the reconstruction of an asset

Company A had a factory that was destroyed by fire. Insurance proceeds have been received and are being used to reconstruct the factory. Company A has a general borrowing pool. Because costs are incurred on the general borrowing pool, is Company A required to capitalise a deemed interest cost in respect of the reconstruction, even though the construction is funded from the insurance proceeds which are lodged in a separate bank account?

The capitalisation of borrowing costs is not necessarily required in these circumstances. The construction of the replacement asset is a distinct event and should be assessed separately for the purpose of determining the appropriateness of capitalisation of borrowing costs.

The general question as to whether an entity is required to capitalise borrowing costs, even when it has identified the source of the funding for the qualifying asset as cash balances, is dealt with in **3.2.2.5**. The only distinction in the case of insurance proceeds is that the entity may be legally required to use the insurance proceeds for the purposes of the reconstruction. When this is the case, the option of repayment of the borrowings is not available, and the borrowing costs are not avoidable. Therefore, the option of capitalising a 'deemed' interest cost is not available in such circumstances.

3.2.2.7 *Impact of tax on capitalised borrowing costs*

Although the Standard does not specifically mention tax, it is clear from the way that borrowing costs are defined that the amount to be capitalised is not affected by whether tax relief will be obtained in respect of borrowing costs (i.e. borrowing costs will be capitalised on a gross basis, and not net of any relevant tax relief). In some jurisdictions, tax relief may be received on borrowing costs when they are incurred, irrespective of whether those costs are capitalised. When this is the case, a temporary difference will arise and the entity should apply the requirements of IAS 12 (see **chapter A13** for further guidance).

3.3 Interaction of capitalisation of borrowing costs and hedge accounting

The interaction between the capitalisation of borrowing costs and hedge accounting is discussed at **2.6** in **chapter C10** (or, for entities that have adopted IFRS 9, **2.6** in **chapter B10**).

3.4 Period of capitalisation

3.4.1 Commencement of capitalisation

IAS 23:17 states that borrowing costs should be capitalised from the commencement date. The commencement date for capitalisation is the date when the following three conditions are first met:

- expenditures for the asset are being incurred;
- borrowing costs are being incurred; and
- activities that are necessary to prepare the asset for its intended use or sale are being undertaken.

Example 3.4.1

Deposit paid for the acquisition of an asset

Company A places an order with a supplier for the acquisition of an asset. The asset will not be received for a substantial period of time. At the time of placing the order, Company A pays a substantial deposit. The remainder of the cost of the asset is paid on delivery.

If Company A incurs borrowing costs in respect of the deposit paid, are these borrowing costs eligible for capitalisation?

In determining whether any borrowing costs incurred are eligible for capitalisation, an assessment is required of all the facts and circumstances and the nature of the deposit paid by Company A. Some common examples are described below.

Deposit represents payment on account under a construction contract

An asset that is manufactured for Company A under a construction contract, in accordance with Company A's specification, is a qualifying asset. The deposit represents a payment on account for construction services.

For example, Company A contracts a supplier to construct a property on Company A's land to Company A's specification based on architects plans provided by Company A. Any payments made by Company A to the supplier are for the construction services provided by the supplier and, therefore, are directly related to the manufacture or construction of the property. Consequently, borrowing costs incurred by Company A during the construction period are eligible for capitalisation and should be capitalised as part of the cost of the asset.

Deposit secures place in a waiting list to acquire standard goods

IAS 23:7 states that "[a]ssets that are ready for their intended use or sale when acquired are not qualifying assets". In such cases, a deposit may primarily serve to secure Company A's place in a waiting list.

A common example is the manufacture of top-end cars when the customer may select from standard customisation options (e.g. paint colour, air conditioning, parking sensors). There is generally a waiting list for such cars. In order to secure its place in the waiting list and guarantee delivery of the new car, Company A may pay a substantial deposit when the order is placed. However, if it is clear that the deposit does not affect the total amount payable to the supplier for the car, any borrowing costs Company A incurs on the deposit do not qualify for capitalisation because they do not arise in relation to the manufacture of the car.

Note that if the payment of the deposit for an asset reduces the overall price that would otherwise have been payable for the asset, it is appropriate to recognise the implicit financing as part of the cost of the asset (see **example 4.3.1C** in **chapter A7** for discussion and illustration).

The term 'activities' in this context is interpreted as having a broad meaning and should include all steps necessary to prepare the asset for its intended use. Such activities include initial technical and administrative work, such as activities associated with obtaining permits, prior to the commencement of the physical construction of the asset. [IAS 23:19]

The mere holding of an asset, however, without any associated development activities, does not entitle an entity to capitalise related borrowing costs. [IAS 23:19] A typical example is the holding of land banks that are not undergoing activities necessary to prepare them for their intended use.

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