Accounting Standard for Local Bodies (ASLB) 5

Borrowing Costs

Contents

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*(This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective and the Preface to the Accounting Standards for Local Bodies[1])*

The Accounting Standard for Local Bodies (ASLB) 5, 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India, will be recommendatory in nature in the initial years for use by the local bodies. This Standard will be mandatory for local bodies in a State from the date specified in this regard by the State Government concerned[2].

The following is the text of the Accounting Standard for Local Bodies.

Objective

This Standard prescribes the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard applies to the entities described as Local Bodies in the Preface to the Accounting Standards for Local Bodies[3].

3. [Refer to Appendix 1]

[1] Attention is specifically drawn to paragraph 4.2 of the '*Preface to the Accounting Standards for Local Bodies*',according to which Accounting Standards are intended to apply only to items which are material.

[2] Reference may be made to the paragraph 7.1 of the '*Preface to the Accounting Standards for Local Bodies*' providing the discussion on the compliance with the Accounting Standards for Local Bodies.

[3] Refer paragraph 1.3 of the '*Preface to the Accounting Standards for Local Bodies*'.

4. This Standard does not deal with the actual or imputed cost of net assets/equity. Where a capital charge is applied to individual entities, judgement will need to be exercised whether the charge meets the definition of borrowing costs or whether it should be treated as an actual or imputed cost of net assets/equity. Charges will be treated as borrowing costs only if it meets the definition of borrowing costs.

Definitions

5. The following terms are used in this Standard with the meanings specified:

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

***Control** is the power to govern the financial and operating policies of another entity so as to benefit from its activities.*

***Controlled entity** is an entity that is under the control of another entity (known as the controlling entity).*

***Controlling entity** is an entity that has one or more controlled entities.*

***Economic entity** means a group of entities comprising a controlling entity and one or more controlled entities.*

***Net assets/equity** is the residual interest in the assets of the entity after deducting all its liabilities.*

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

Borrowing Costs

6. Borrowing costs may include:

   (a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

(b) amortisation of discounts or premiums relating to borrowings;

(c) amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

(d) finance charges in respect of assets acquired under finance leases or under similar arrangements; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowing costs to be accounted for under this Standard and the remaining exchange difference, if any, will be accounted for under Accounting Standard for Local Bodies (ASLB) on *'The Effects of Changes in Foreign Exchange Rates'*[4]. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the entity would have raised the borrowings locally had the entity not decided to raise the foreign currency borrowings. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, *'The Effects of Changes in Foreign Exchange Rates'*, until the ASLB on this subject is formulated.

The application of this explanation is illustrated in the Appendix A.

Economic Entity

7. The term "economic entity" is used in this Standard to define, for financial reporting purposes, a group of entities comprising the controlling entity and any controlled entities.

[4] The Accounting Standard for Local Bodies is under preparation.

8. Other terms sometimes used to refer to an economic entity include “administrative entity”, “financial entity”, “consolidated entity” and “group”.

9. An economic entity may include entities with both social policy and commercial objectives. For example, a local body XYZ (controlling entity) may control by way of majority voting power in an entity ABC (controlled entity) that provides services of health care for a nominal charge, as well as another entity PQR (controlled entity) that provides transport services on a commercial basis. The group of entities comprising local body XYZ and the controlled entities, viz., ABC and PQR, is the economic entity.

10-11. [Refer to Appendix 1]

Net Assets/Equity

12. “Net assets/equity” is the term used in this Standard to refer to the residual measure in the balance sheet (assets less liabilities). Net assets/equity may be positive or negative. Other terms may be used in place of net assets/equity, provided that their meaning is clear.

Qualifying Assets

12A. What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get ready for its intended use or sale should be considered.

13. Examples of qualifying assets are office buildings, hospitals, infrastructure assets such as roads, bridges and power generation facilities, and inventories that require a substantial period of time to bring them to a condition ready for use or sale, and investment properties. Other investments and those inventories that are routinely produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

14-16. [Refer to Appendix 1]

17. Borrowing costs should be recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised in accordance with paragraph 13.

18. Borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard.

19. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits or service potential to the entity and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

20. [Refer to Appendix 1]

20A. When an entity borrows funds generally and uses them for the purposes of obtaining a qualifying asset, the entity recognises an expense for the borrowing costs in respect of such funds in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

21. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified. Funds sourced from general borrowings of the entity are not specifically incurred and costs related to such borrowings are not eligible for capitalisation.

22. Funds that have been borrowed centrally may be transferred to other entities within the economic entity as a loan, a grant or a capital injection. Some loans may be interest-free or require that only a portion of the actual interest cost be recovered and grants or capital injections do not normally incur interest. Borrowing costs in respect of such borrowings do not qualify for capitalisation.

23. To the extent that an entity borrows funds specifically for the purpose of acquiring, constructing or producing a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

24. The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditures on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any income earned on temporary investment of such funds is deducted from the borrowing costs incurred.

25. [Refer to Appendix 1]

26. If a controlling entity borrows funds which are then loaned to a controlled entity, the controlled entity may captalise only those borrowing costs which it itself incurs specifically in relation to the acquisition, construction or production of a qualifying asset. Such costs will normally be documented in loan agreement with the controlling entity. Where a controlled entity receives an interest-free capital contribution or capital grant, it will not incur any borrowing costs and consequently will not capitalise any such costs.

27. When a controlling entity transfers funds at partial cost to a controlled entity, the controlled entity may capitalise that portion of borrowing costs which it itself has incurred specifically for the acquisition, construction or production of a qualifying asset. These borrowing costs are not necessarily identical to the borrowing costs incurred by the controlling entity. In the financial statements of the economic entity, the full amount of borrowing costs specifically incurred for the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that qualifying asset, provided that appropriate consolidation adjustments have been made to eliminate those costs capitalised by the controlled entity.

28. When a controlling entity has transferred funds at no cost to a controlled entity, neither the controlling entity nor the controlled entity would meet the criteria for capitalisation of borrowing costs in their separate financial statements. However, if the economic entity met the criteria for capitalisation of borrowing

costs, it would be able to capitalise the borrowing costs to the qualifying asset in its financial statements.

29. [Refer to Appendix 1]

29A. When a controlling entity borrows funds generally, and lends part of those funds to a controlled entity specifically for the acquisition, construction or production of a qualifying asset, the borrowing costs of the controlling entity are not eligible for capitalisation either by that controlling entity in its separate financial statements or by the economic entity in its consolidated financial statements. The borrowing costs of the controlled entity may, however, be eligible for capitalisation in the controlled entity's separate financial statements. If the controlling entity borrows funds specifically for the acquisition, construction or production of a qualifying asset by a controlled entity, those borrowing costs, if transferred to the controlled entity, are capitalised in the separate financial statements of the controlled entity and in the consolidated financial statements of the economic entity.

Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

30. When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Accounting Standards for Local Bodies. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those Accounting Standards.

Commencement of Capitalisation

31. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:

- ***(a) expenditure for the acquisition, construction or production of qualifying asset is being incurred;***
- ***(b) borrowing costs are being* incurred *specifically for the acquisition , construction or production of a qualifying asse*t; *and***

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

32. Expenditures on a qualifying asset include only such expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest bearing liabilities. The expenditure is reduced by any progress payments received and grants received in connection with the asset.

33. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of Capitalisation

34. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted. Such borrowing costs are expensed.

35. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

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

37. An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that is outstanding, this indicates that substantially all the activities are complete.

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

39. Example of a qualifying asset for which each part is capable of being used while construction continues for the other parts is an office development comprising several buildings, each of which can be used individually. Examples of qualifying assets that need to be completed before any part can be used include an operating room in a hospital when all construction must be complete before the room may be used; a sewage treatment plant where several processes are carried out in sequence at different parts of the plant; and a bridge forming part of a highway. In such cases, capitalisation of borrowing costs should be continued.

Disclosure

40. The financial statements should disclose:

- ***(a) the accounting policy adopted for borrowing costs incurred specifically for the acquisition, construction or production of a qualifying asset; and***

- ***(b) the amount of borrowing costs capitalised during the period.***

41-43. [Refer to Appendix 1]

Appendix A

Illustration 1

Note: This appendix is illustrative only and does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of the paragraph 6 (e) of the standard.

Facts:

Local Body XYZ has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by Local Body XYZ in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 6(e) of this Accounting Standard for Local Bodies:

(i) Interest for the period = USD 10,000 x 5% x Rs. 48/USD = Rs. 24,000

(ii) Increase in the liability towards the principal amount = USD10,000 x (48-45) = Rs. 30,000

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 x 45 x 11% = Rs. 49,500

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 – Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 6(a) of this *Accounting Standard for Local Bodies*) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per this *Accounting Standard for Local Bodies* and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard for Local Bodies (ASLB) on '*The Effects of Changes in Foreign Exchange Rates'*[5]. Guidance on accounting for the effects of changes in foreign exchange rates can be found in Accounting Standard (AS) 11, '*The Effects of Changes in Foreign Exchange Rates*', until the ASLB on this subject is formulated.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., Rs. 34,500 (Rs. 58,500 – Rs. 24,000)) is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under this Accounting Standard for Local Bodies and there would be no exchange difference to be accounted for under proposed ASLB on '*The Effects of Changes in Foreign Exchange Rates'*.

[5] The Accounting Standard for Local Bodies is under preparation.

Appendix 1

Note: This Appendix is not a part of the Accounting Standard for Local Bodies. The purpose of this appendix is only to bring out the major differences between this Accounting Standard for Local Bodies (ASLB) and the corresponding International Public Sector Accounting Standard (IPSAS) 5, Borrowing Costs issued by International Public Sector Accounting Standards Board.

Comparison with IPSAS 5, *Borrowing Costs*

1. Capitalisation of Borrowing Costs

IPSAS 5 prescribes the expensing of the borrowing costs as 'benchmark treatment'. However, in relation to the borrowing costs directly attributable, (both specifically and generally incurred), to the acquisition, construction or production of a qualifying asset, it provides an option of capitalising such borrowing costs in the cost of that asset. Recently, International Public Sector Accounting Standards Board (IPSASB) has issued ED 35 that proposes amendments to IPSAS 5 which inter alia include that the borrowing costs related to general borrowings are not eligible for capitalisation.

As compared to above, ASLB 5 does not prescribe expensing of borrowing costs as in IPSAS 5. It requires capitalisation of borrowing costs. However, keeping in view the initial stage of introduction of accrual accounting in Local Bodies, the ASLB 5, 'Borrowing Costs', incorporates the amendments proposed in the ED 35 requiring that only those borrowing costs that are specifically incurred for the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Thus, ASLB 5 does not require capitalisation of borrowing costs arising from general borrowings as presently required in IPSAS 5. In this regard, paragraph 20A has been incorporate to provide guidance.

2. Substantial Period of Time

IPSAS 5 does not provide the meaning of the expression 'substantial period of time'. It provides only examples of the qualifying Asset requiring the substantial period of time. ASLB 5 provides the interpretation of the expression 'substantial period of time'. In this regard, paragraph 12A has been incorporate in the ASLB

5. It provides that ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case.

3. Commitment Charges

ASLB 4 provides that the Borrowing Costs may include commitment charges on bank borrowings. However, IPSAS 5 does not provide for including the commitment charges on bank borrowings.

4. Paragraph Deleted

Following paragraphs have been deleted in ASLB 5. However, their numbers have been retained in order to maintain consistency with the corresponding IPSAS 5.

Paragraph 3 and 11 : Not relevant for Local Bodies as it pertain to Government Business Enterprises (GBEs).

Paragraph 10 : Paragraph defining 'Assets' has been deleted in order to include the same in ASLB 1 or Conceptual Framework for General Purpose Financial Reporting by Local Bodies.

Paragraph 14-16 : Paragraph pertaining to expensing of borrowing as benchmark treatment have been deleted.

Paragraph 20, 25 and 29 : Paragraphs pertaining to capitalisation of borrowing costs in respect of general borrowings have been deleted.

Paragraph 41, 42 and 43 : Paragraphs pertaining to transitional provisions and effective date have been deleted as the ASLBs would become mandatory for Local Bodies in a State from the date specified by the State Government concerned.