Capitalisation of Borrowing Costs

The following is the brief version of an opinion given by the Expert Advisory Committee of the Institute in response to query sent by a member. This is being published for the information of readers.

A. Facts of the Case

1. A company was incorporated in 1996 under the Companies Act, 1956, to conduct various educational and consulting programmes. The company plans to construct a training institute-cum-corporate office and had applied to a state development authority for allotment of 20,000 sq.m. of land on 'as is where is basis' on lease for a period of 90 years commencing from the date of execution of the lease deed.
2. The company received a letter dated March 16, 2002, from the state development authority confirming reservation of approximately 20,000 sq. m. of land at a premium of Rs.170 lakh and the first installment equivalent to 10% of the total premium was paid by the company on April 16, 2002.
3. The company received a letter of allotment dated April 24, 2002 from the state development authority whereby the company was required to deposit allotment money equivalent to 20% of the total premium before June 23, 2002, with an option to pay the entire balance of the premium immediately or in twelve half-yearly installments at an interest of 14% per annum payable at the end of each half year. The first installment was due on December 22, 2002 and the last installment is due on June 23, 2008. The total installments to be paid aggregate to Rs. 230.79 lakh (including reservation/allotment money) which includes total interest of Rs. 60.79 lakh. The allotment money of Rs. 34 lakh was paid by the company on June 23, 2002.
4. The company received a letter dated October 22, 2002 from the state development authority confirming finalisation of the lease plans and the following amounts that are to be paid by the company in respect of the lease of land:

	Rs.(in lakh)
Lease rent, if paid one time	46.75
Lease rent, if paid per annum	4.25
Stamp Duty	31.41

The lease deed was executed on July 20, 2004 and possession of the land was obtained on July 26, 2004.

5. On August 7, 2002, the company filed an application with a bank requesting for a term loan of Rs. 560.18 lakh towards cost of land and construction of the building in phase I and phase II. The total cost of the project is estimated at Rs. 800.25 lakh and the term loan from the bank is proposed to be utilised as shown in the table below:

	Rs.(in lakh)
Cost of land	119.00
Others	15.75
Construction of Building – phase I	242.55
Construction of Building – phase II	182.88
Total	**560.18**

The balance cost of the project of Rs. 240.07 lakh is proposed to be financed by internal accruals and by the promoters of the company. Construction of phase I was proposed to be completed by March 2004 and phase II by December 2004.

6. On May 7, 2003, the company received a letter from the bank confirming its willingness to provide a term loan of Rs. 400 lakh at an interest of 12% per annum payable monthly. The loan is repayable in forty-eight equated monthly installments commencing from May, 2004 to April, 2008. The term loan of Rs. 400 lakh is proposed to be utilised in proportion to the cost components as stated in paragraph 5. The loan processing fee of Rs. 4 lakh was paid by the company on May 9, 2003. Till date the company has not drawn the term loan of Rs. 400 lakh.

7. Upto March 31, 2004, the company has paid Rs. 68.87 lakh to the state development authority towards premium for the leasehold land and Rs. 26.98 lakh towards interest on the unpaid balance of premium and the total consideration of Rs. 95.85 lakh has been recorded in the books of account as capital advance under 'Fixed Assets'. The loan processing fee of Rs. 4 lakh has also been recorded as capital advance under 'Fixed Assets'. The company proposes to capitalise the consideration of Rs. 95.85 lakh (including interest) and loan processing fee of Rs. 4 lakh on the date of possession of the leasehold land.
8. During the year ended March 31, 2005, the company has paid an additional installment of Rs. 29.96 lakh (including interest of Rs. 9.68 lakh) to the state development authority towards premium for the leasehold land and annual lease rent of Rs. 4.25 lakh. The company proposes to capitalise the consideration of Rs. 29.96 lakh (including interest) and annual lease rent of Rs. 4.25 lakh as at March 31, 2005.

B. Query

9. The querist has raised the following issues for the opinion of the Expert Advisory Committee:
   (i) Whether acquisition of land will be termed as a qualifying asset within the meaning of paragraph 3 of Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Institute of Chartered Accountants of India. The company has contended that land is an integral part of the project for construction of a training institute-cum-corporate office and should be a qualifying asset within the purview of AS 16 even though construction of the project has not yet commenced.
   (ii) Whether the company can capitalise the interest of Rs. 26.98 lakh that has been paid upto March 31, 2004 and Rs. 9.68 lakh that has been paid after March 31, 2004, in respect of unpaid premium on land even though the company has not obtained any loan from the bank or from any other source as at March 31, 2004 or even thereafter.
   (iii) Whether the company can capitalise the loan processing fee of Rs. 4 lakh that was paid on May 9, 2003, if the loan is drawn after March 31, 2004. In the event the existing offer of term loan is cancelled and a fresh loan is drawn from another bank, whether the loan processing fee that was paid on May 9, 2003, can be deferred/capitalised and amortised over the period for which the loan remains unpaid.
   (iv) Whether the company can capitalise future interest in respect of unpaid premium on land that is paid after the loan is drawn and also after completion of construction of the project.
   (v) On possession of the leasehold land, the company proposes to capitalise the premium on leasehold land for Rs. 230.79 lakh (including interest of Rs. 60.79 lakh). Whether the company can capitalise unpaid interest in respect of premium on land irrespective of whether such payments are proposed to be made in future through internal accruals or after the loan is drawn.
   (vi) The company proposes to defer all payments in respect of annual lease rent of Rs. 4.25 lakh till completion of the project and capitalise such rent under the head 'Building'. Whether such capitalisation is permitted keeping in view the 'Guidance Note on Treatment of Expenditure During Construction Period', issued by the Institute of Chartered Accountants of India.
   (vii) Whether the stamp duty of Rs. 30.41 lakh paid on registration of leasehold land can be capitalised as value of leasehold land.

The company has contended that the issues referred to in paragraphs (i) to (v) above should be capitalised as they are in conformity with AS 16.

C. Points considered by the Committee

10. The Committee notes the definition of the term 'qualifying asset' as per AS 16 and paragraph 16 thereof as reproduced below:

"A qualifying asset is an asset that necessarily takes a substantial period of time to

get ready for its intended use or sale."

"16. 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."

11. The Committee is of the view, on the basis of the above, that the land acquired by the company cannot be considered as a qualifying asset within the meaning of AS 16 since no development work thereon is being undertaken. The argument that acquisition of land is an integral part of the project of construction of the corporate office and training institute is not valid since each asset necessary for the project should be considered separately for the purpose of deciding whether it constitutes a 'qualifying asset' within the meaning of AS 16. 'Land' and 'Building' in any case are considered separate assets.

12. The Committee notes from paragraph 1 of the facts of the case that the company has acquired the land on lease for 90 years. The Committee is of the view that in respect of the lease agreements for long periods, e.g., 90 years, it is generally expected that either the lease period would be extended or the title will pass to the lessee at some agreed amount. Therefore, in substance, the lease of land for a period of 90 years amounts to transfer of the significant rights of ownership in the land to the lessee and thus, it should be shown as a 'fixed asset' in the books of the lessee along with proper disclosures about the nature of lease, term of lease period, etc. Further, with regard to stamp duty paid on registration of leasehold land, the Committee notes paragraph 9.1 of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', issued by the Institute of Chartered Accountants of India, which, inter alia states as follows:

"9.1 The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use;…"

In this context, the Committee also notes the following extracts from paragraph 9.6 of the 'Guidance Note on Treatment of Expenditure During Construction Period', issued by the Institute of Chartered Accountants of India:

"9.6 …In addition to the actual cost of land, various expenses may be incurred in connection with the land which should also be capitalised. These expenses would include the following:-

(a) Legal costs, stamp duties and fees, etc.

…"

From the above, the Committee is of the view that stamp duty paid on registration of leasehold land is a cost directly attributable to the acquisition of land and accordingly, should be capitalised as a part of the cost of land.

D. Opinion

13. On the basis of the above, the opinion of the Committee on the issues raised by the querist in paragraph 9 is as follows:
    - (i) Acquisition of land cannot be termed as a qualifying asset within the meaning of AS 16.
    - (ii) to (v) In view of the answer at (i) above, these questions do not arise.
    - (vi) Annual lease rent paid in respect of land cannot be capitalised as part of the cost of 'building'.
    - (vii) Stamp duty paid on registration of leasehold land should be capitalised as a part of the cost of land.

Notes:

1. The Opinion is only that of the Expert Advisory Committee and does not necessarily represent the Opinion of the Council of the Institute.
2. The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in twenty three volumes which are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.