Capitalisation of Borrowing Costs

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

A. Facts of the Case

1. A Government company wholly owned by the Government of India, registered under the Companies Act, 1956, commenced its business in September 1987. The core business of the company is power generation at its power stations located across India. The power is fed into the regional grids and is shared by various states as per the allocation made by the Ministry of Power, Government of India and agreement with beneficiary states.

2. The querist has stated that the borrowing of funds is a centralised function at head office and is not on the basis of specific project appraisal. The borrowing is on the basis of statement of affairs of the company and is made for two or three projects in common and not on the basis of borrowing for one specific project. Sometimes, the loan was raised for a project even after the completion of substantial construction activity in that particular project. The interest is allocated on the actual utilisation of funds for each project. On unutilised funds, the allocation of interest to any specific project is not practical as the quantification of loan amount attributable to each specific project is not workable/possible.

3. The company, during the year, had raised common loans (both domestic and foreign currency) for various projects in general and not specifically for any particular project. Even while raising such loans, amount of loans attributable to a particular project was not known, it was determined only when the loan was actually utilised at the project sites as per level of construction activities undertaken. Sometimes even a portion of the loan was utilised for a project other than the project for which loan was actually taken.

4. The querist has further stated that as the borrowing of funds for the future projects is a corporate function, the interest allocation was made on the basis of actual utilisation of funds for each project for capitalisation of interest during construction. On unutilised funds, the allocation of interest to any specific project was not practical as the quantification of loan amount attributable to one specific project was not ascertainable and the borrowing was made generally for two or more projects in common. Accordingly, the interest cost attributable to unutilised funds was charged to the statement of profit and loss.

5. Till the time, the borrowed funds for the projects were utilised, these were kept at head office in a common pool of funds, which were used for various other purposes. Apart from this, as the company was also having sufficient surplus funds, these funds along with the unutilised funds of project borrowings were invested on short-term and long-term basis keeping in view the future requirement. The interest income earned on these investments was credited to the statement of profit and loss.

6. It may thus be noted that the borrowings made by the company were common for various projects in general and not for a specific project. Loan amount attributable to a specific project was also not identified/quantified in the loan agreements executed with various banks. The utilisation of loans was made progressively based on the construction activities undertaken at various project sites. Till that time, the unutilised loan funds were kept at head office which got mixed up with the common pool of funds which was used for various purposes. Therefore, under such circumstances, it becomes difficult rather impossible to identify a particular project to which the unutilised loan fund relates and the attributable interest cost to a specific project.

7. *Recognition Principle*
   The recognition principles as per paragraphs 6 and 7 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as 'the Rules') are:

"6. Borrowing costs that are directly attributable to 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. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

7. 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 to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred."

As per the recognition principle, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset.

Paragraphs 8, 10 and 11 of AS 16, notified under the 'Rules' further provide the following:

"8. …When an enterprise 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."

"10.To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

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

8. The auditors while conducting the audit of annual accounts of the company have raised a query that as the company borrowed funds exclusively for meeting capital expenditure and not for the working capital or for other purposes, the entire borrowing costs should be charged to the projects and the interest, if any, earned on their temporary investment should be credited to the concerned projects as per paragraph 10 of AS 16.

9. The auditors have further observed that the company had not separately accounted for the interest earned on these funds lying with the head office during the interim period when they were clubbed with other funds.

10. The audit query related to under capitalisation of borrowing cost has been reviewed by the company as per the provisions of AS 16. The justification in support of accounting treatment of borrowing cost made in the books of account for preparation of the financial statements of the company is as under:

As per paragraph 6 of AS 16, notified under the 'Rules', ***"Borrowing costs that are directly attributable to 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. Other borrowing costs should be recognised as an expense in the period in which they are incurred."*** Paragraph 7, inter alia, states that borrowing costs are capitalised as part of the cost of a qualifying asset when such costs can be measured reliably.

Paragraphs 8 and 9 of AS 16, notified under the 'Rules' further state as follows:

"8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an enterprise 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.

9. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset… for example, when the financing activity of an enterprise is co-ordinated centrally … and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required."

Paragraph 12 of AS 16, notified under the 'Rules' further, inter alia, states that, ***"To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset."***

11. Accordingly, for the measurement of borrowing costs eligible for capitalisation, AS 16 provides two circumstances, one specific borrowing and other when funds are borrowed generally for acquisition, construction or production of a qualifying asset. According to the querist, paragraph 10 of AS 16 applies only when there is a borrowing for a specific project. It may also apply to a new company in a project stage without any commercial operation. Paragraph 12 of AS 16 applies in other cases.

12. It may, however, be seen from the above paragraphs that the system of borrowing adopted by the company is to borrow the funds commonly for various projects in general and not for the purpose of any specific project. Loan amount attributable to a specific project was also not identified/quantified in the loan agreements executed with various banks. The utilisation of loan funds has been made progressively based on the construction activities undertaken at various project sites. Till that time the unutilised loan funds were kept at head office and got mixed in the common pool of funds. Therefore, under such circumstances it becomes difficult rather impossible to identify a particular project to which the unutilised loan fund relates. When it is impossible to identify a particular project to which the unutilised loan fund relates, it is also impossible to measure reliably the related borrowing cost attributable to a particular project. As a result, it was impossible for the company to follow paragraph 10 of AS 16 and quantify the interest (on unutilised funds) attributable to each specific project.

B. Query

13. In the light of the aforementioned facts, the querist has sought the opinion of the Expert Advisory Committee of the Institute of Chartered Accountants of India on the following issues:

    (i) whether the accounting treatment carried out by the company, i.e., capitalising the interest on the portion of funds utilised for capital projects as capital expenditure and charging off the balance amount of interest on the unutilised portion of the funds available with the company to the statement of profit and loss, even though these were raised for two to three projects as mentioned above, is correct.

    (ii) whether whole of the interest on unutilised portion of funds need to be capitalised even though the funds were not actually utilised on any of the projects under construction.

C. Points considered by the Committee

14. The Committee notes that the basic issues raised in paragraph 13 above of the query relate to capitalisation of interest on the portion of borrowed funds utilised for capital projects as capital expenditure and accounting for the balance amount of interest on the unutilised portion of the funds available with the company. The Committee has, therefore, considered only these issues and has not examined any other issue arising from the Facts of the Case, such as, determination of qualifying assets, determination of point of time when the borrowing costs should cease to be capitalised, treatment of interest income earned from the investment of unutilised portion of the borrowings and its allocation to various projects under construction, determination of capitalisation rate applicable to borrowed funds, accounting for internal surplus funds used for financing the

qualifying asset, accounting for foreign exchange fluctuations on the foreign currency borrowings, etc. The Committee notes from the Facts of the Case that the funds have been borrowed generally and not specifically for any project. Further, these borrowings are only for meeting capital expenditure and not for working capital requirements or other purposes. Accordingly, the Committee has restricted itself to these general borrowings only. The Committee also notes from the Facts of the Case (paragraph 5 above) that "as the company was also having sufficient surplus funds, these funds along with the unutilised funds of the borrowings were invested on short-term and long-term basis keeping in view the future requirement". Since the querist has not raised the issue with respect to determination of expenditure on qualifying assets out of borrowed funds and surplus funds accrued internally, the Committee has not examined that issue and presumed that the issue raised in the query is with respect to borrowed funds only which are being used for construction activities.

15. The Committee notes paragraphs 12 and 14 of AS 16, notified under the 'Rules' as reproduced below:

> ***"12. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period."***
>
> ***"14. 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 a qualifying asset is being incurred;***
>
> ***(b) borrowing costs are being incurred; and***
>
> ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress."***

From the above, the Committee notes that to the extent that funds are borrowed generally, (i.e., without specifying any particular project) and *used* for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. In the extant case, the company raised common loans for various projects in general and utilisation of loans was made progressively based on the construction activities undertaken at various project sites. Accordingly, it may be difficult to identify exact amount of borrowing funds utilised for a particular project. However, determining to what extent general borrowings have been used for a specific project, is a question of fact and should be determined by exercising the best judgement considering various factors, for example, information related to cash inflows and outflows.

16. The Committee is further of the view that to capitalise the borrowing costs, it is not sufficient that the funds are generally borrowed for meeting capital expenditure and not for the working capital or other purposes, as argued by the auditors; it is also essential that the funds from those borrowings should be *used* for the purpose of obtaining a qualifying asset. The Committee notes from the Facts of the Case that there were general borrowings which were not even utilised for any project of the company during the period. Accordingly, the Committee is of the view that borrowing costs related to only utilised funds for the purpose of any project should be capitalised by applying weighted capitalisation rate as per paragraph 12 of AS 16, subject to the satisfaction of the conditions specified in paragraph 14 of AS 16 and borrowing costs related to unutilised funds should be charged to the statement of profit and loss.

D. Opinion

17. On the basis of the above, the opinion of the Committee on the issues raised in paragraph 13 above is as below:
    (i) The accounting treatment carried out by the company, i.e., capitalising the interest on the portion of generally borrowed funds (raised without specifying any particular project) utilised for capital projects as capital expenditure and charging off the balance

amount of interest on the unutilised portion of the funds available with the company to the statement of profit and loss is correct provided the conditions as per paragraphs 12 and 14 of AS 16 are met, as discussed in paragraphs 15 and 16 above.

(ii) No, the interest on unutilised portion of funds should not be capitalised as discussed in paragraphs 15 and 16 above.

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 Opinion is based on the facts supplied and in the specific circumstances of the querist. The Committee finalised the Opinion on December 26-27, 2012. The Opinion must, therefore, be read in the light of any amendments and/or other developments subsequent to the issuance of Opinion by the Committee.
3	The Compendium of Opinions containing the Opinions of Expert Advisory Committee has been published in thirty volumes. A CD of Compendium of Opinions containing thirty volumes has also been released by the Committee. These are available for sale at the Institute's office at New Delhi and its regional council offices at Mumbai, Chennai, Kolkata and Kanpur.
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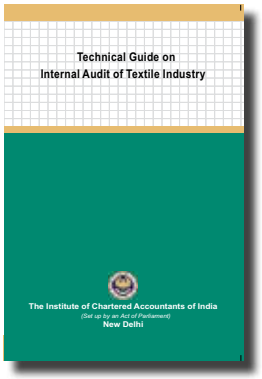

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