Capitalisation of Interest Cost

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 company has set up a new plant to manufacture auto components in which it has incurred capital expenditure of around ₹415 million on new plant and equipment and other infrastructural facilities as per details mentioned below:

Particulars	Amount (INR- Mil)
Building- Improvement	8.88
Furniture & Fixtures	6.13
Office Equipment	5.83
Plant & Machinery	393.73
Software	0.08
Vehicles	1.21
Total - A	415.86
Capital Work in Process – Others	1.19
Capital Work in Process - Plant & Machinery	0.72
Total - B	1.92
Grand Total	417.78

2. The querist has informed that in wiring harness industry, plant set-up involves setting up of cutting and crimping machine, conveyor, and assembly line for wiring harness and plant utilities such as air handling unit (AHU), compressor, floor painting, etc. after the building is completed and handed over, followed by customer trial and audit. The lead time for procurement of equipments is around 6 to 8 months from the date of order and the entire set-up including customer audit takes around 9-10 months. Normal time period taken from ordering the machines to installation and commissioning including customer audit to make the plant ready for manufacturing is around 8-10 months. With regard to building improvement, the querist has separately informed that the cost incurred for building improvement is mainly in the nature of air handling unit, epoxy flooring, plant electrification and networking and landscaping. The electrical work is done for the manual process of wiring harness maintaining 500 lux. Air handling units are installed for maintaining the internal temperature for easiness of operator's working.

3. The querist has referred to paragraph 3.2 of Accounting Standard (AS) 16, 'Borrowing Costs', which states as follows:

   "3.2 A <u>qualifying asset</u> is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

   Explanation:

   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 it ready for its intended use or sale is considered."

4. Based on facts and circumstances of the industry, the querist is of the opinion that standard time of 8-10 months taken to set up a plant to manufacture wiring harness should be considered to meet the criteria of qualifying assets as per AS 16. Further, the plant has been set up in a factory building that was built by a third party (landlord) to suit as per the company's specifications. The company had taken this customised building on lease from the landlord for a period of nine years, with a lock-in period of 5 years. The landlord had incurred an amount of around ₹147 million in the construction of this building. With regard to the factory building, the querist has separately informed that the landlord had constructed the factory building on a vacant piece of land. The company contacted the landlord and he was interested to construct the building as per the requirements of the company and let out on rent. The company did not pay any customisation cost separately; it was included in agreed rent. The building design, specifications and layout were specified by the company to suit wiring harness manufacturing. Some of the specific customisations

done to suit the requirements of the company are as follows:

1. Production floor, shed height, utility, all support departments were built to suit the company's needs.
2. Roads were designed as per the requirements of the company.
3. Creche, employee gate, material gate constructed as per the requirements of the company.

   The aforesaid customisation was done for the company specifically at the instance of the company, however, the landlord had acted independently. The construction was carried out under the supervision of architects, nominated by the company. The company had entered into a 9 years rental agreement with 5 years lock in period that covers the entire cost of construction.

5. The company had entered into a Memorandum of Understanding (MoU) with the landlord to construct this customised building on 5th September, 2014. The landlord had taken a period of 12 months to complete the construction and handed over the building to the company after a period of 14 months. Thereafter, the company installed its equipment and created other infrastructure to make the plant operational. The key milestones and dates for creation of this plant are as follows:
   i. Date of MoU with landlord for construction of customised factory building: 5th September, 2014
   ii. Date of completion and handover of the building by the landlord: October 2015
   iii. Date of signing of lease agreement with landlord: August 2015
   iv. Date of first order for plant and equipment: June 2015
   v. Date of installation and capitalisation of the plant: 1st March, 2016
   vi. Date of audit by the company's customer and clearance for manufacturing and supply from the plant: 8th March, 2016
6. The querist has further stated that this is a major manufacturing project that the company has undertaken during the previous year and the entire capital expenditure that is incurred is funded through a term loan from bank. During the construction period, the company had incurred an amount of ₹420 million on the term loan taken to fund the project. Considering the aforesaid facts, the company is of the opinion that the assets installed in the said plant can be treated as 'qualifying assets' under Accounting Standard 16 and, therefore, the interest of ₹4.9 million incurred during the pre-operative period needs to be capitalised on the assets that it has procured and installed.

B. Query

7. On the basis of above, the querist has sought an opinion from the Expert Advisory Committee as to whether considering the fact that the overall project (including the construction of the building) has taken a period of 18 months for completion, the assets procured and installed in the said plant would be treated as 'qualifying assets' under the Accounting Standard 16 and whether the interest of ₹4.9 million incurred during the pre-operative period in procurement of the assets needs to be capitalised.

C. Points considered by the Committee

8. The Committee notes that the basic issues raised in the query relate to whether the assets procured and installed in the said plant would be treated as 'qualifying assets' and whether the interest of ₹4.9 million incurred during the pre-operative period in procurement of the assets needs to be capitalised. The Committee has, therefore, considered only these issues and has not examined any other issue that may arise from the Facts of the Case, such as, accounting for lease of building, whether the building is acquired on 'operating lease' or 'finance lease', accounting for lease rent paid during the period when the plant is getting ready for its intended use, accounting for capital expenditure incurred on building improvements, etc.
9. At the outset, the Committee notes that the company has incurred an expenditure on the new plant which is the entire set-up including building improvements, furniture and fixtures, office equipment, software, vehicles etc. apart from the plant and machinery and the issue now being raised is whether the assets installed in the said plant can be treated as a 'qualifying asset' under AS 16 and therefore, the interest of ₹4.9 million incurred during the pre-operative period needs to be capitalised on the assets that it has procured and installed. It appears that the company is treating the plant/entire set-up as a single qualifying asset for capitalisation of borrowing costs. Now the question that arises is whether the entire plant

consisting of various assets can be considered as a 'qualifying asset' viz., the asset that necessarily takes a substantial period of time to get ready for its intended use. In this context, the Committee notes that the plant in the extant case consists of various assets, which are acquired by the company at different points of time. Therefore, the Committee is of the view that the company should evaluate whether these assets can be considered to be ready for their intended use only when the entire plant is ready for its intended use. In case, any of the assets of the plant can be considered to be ready for its intended use before the plant is ready, it should be considered as a separate qualifying asset provided it meets the definition of 'qualifying asset' as per the requirements of AS 16 and the considerations discussed in paragraph 10 below.

10. The Committee further notes the definition of the term 'qualifying asset' and paragraph 5 of Accounting Standard (AS) 16, 'Borrowing Costs', notified under the Companies (Accounting Standards) Rules, 2006 (hereinafter referred to as the 'Rules'), which are reproduced below:

    "3.2 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

    Explanation:

    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 it ready for its intended use or sale is considered."

    "5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis 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."

11. The Committee notes from paragraph 3.2 of AS 16 that ordinarily twelve months is considered as substantial period of time. However, a shorter or longer period can be justified considering the peculiarities of the facts and circumstances of each case. In estimating this period, the time which an asset takes, technologically and commercially, to get ready for its intended use should be considered. Thus, the Standard does not specify the exact period which may be considered for determining what constitutes substantial period of time. Accordingly, the Committee is of the view that determination of 'substantial period of time' is a matter of judgement, which the management should exercise and the auditor should verify in the specific facts and circumstances of the case considering various factors, such as, nature of the asset, nature of the construction activity, normal time that the asset necessarily takes technologically and commercially to get ready for its intended use, etc. In this regard, the Committee also notes that the querist has stated that the lead time for procurement of equipments is around 6 to 8 months from the date of order and the entire set-up including customer audit takes around 9-10 months. It is also mentioned that the normal period taken from ordering the machines to installation and commissioning including customer audit to make the plant ready for manufacturing is around 8-10 months. Thus, the time taken from the order till capitalisation of the plant is around 8-10 months which is shorter than 12 months. Therefore, the Committee is of the view that in the extant case, the company should itself evaluate its own facts and circumstances considering various factors, as aforementioned and determine whether the time taken by the plant in the extant case can constitute 'substantial period of time' and on that basis, whether the plant is a qualifying asset or not. In this regard, the Committee notes that the building has been customised for the purposes of the company. Whether the time taken in such customisation should be or not be considered for the purposes of determination of qualifying asset under AS 16 would depend on the specific facts and circumstances of the case considering various factors, for example, in case building is acquired on finance lease.

12. Further, the Committee notes from the Facts of the Case that various activities upto the customer trial and audit are undertaken for set up of the plant, which are financed through borrowed funds. In this regard, the Committee notes the

following paragraphs of AS 16, notified under the 'Rules':

> ***"14. The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when all the following conditions are satisfied:***
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> ***(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***
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> ***(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."***
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> "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."

The Committee notes from the Facts of the Case that the manufacture/construction of the plant and machinery, which is a significant component of the plant was performed by the vendor before it is commissioned at the construction site. The conditions for commencement of capitalisation are clearly laid down in paragraph 14 of AS 16. The Committee is of the view that though there are no restrictions for capitalising the borrowing costs incurred on assets manufactured at a vendor site, all the conditions of paragraph 14 above should be satisfied for capitalisation of borrowing costs. The expenditure on the qualifying asset and payment of borrowing costs are not sufficient enough to capitalise the borrowing costs. The activities that are necessary to prepare the asset for its intended use or sale should also be in progress so as to satisfy the conditions for capitalisation. The activities necessary to prepare the asset for its intended use or sale can vary depending on facts and circumstances of each case. The Committee is of the view that 'activities necessary to prepare the asset for its intended use or sale' are the activities which lead to any active development/construction of the asset that lead to change in the asset's condition/location. Accordingly, the various activities in the extant case, for example, customer trial and audit, should be carefully analysed to determine whether these meet the above-mentioned criteria considering various factors, such as, whether any modifications are required after customer trial and audit leading to change in the asset's condition, etc.

D. Opinion

13. On the basis of the above, the Committee is of the opinion that the company should itself evaluate in its own facts and circumstances considering various factors, as discussed in paragraph 10 above and determine whether the time taken by the plant in the extant case can constitute 'substantial period of time' and on that basis, whether the plant is a qualifying asset or not. Further, the interest incurred during the pre-operative period should be capitalised only for the period when the activities that are necessary to prepare the asset for its intended use or sale are in progress and when other conditions for capitalisation of borrowing costs as per AS 16 are being fulfilled, as discussed in paragraph 12 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 January 16, 2017. 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 five volumes. A CD of Compendium of Opinions containing thirty five 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.
4.	Recent opinions of the Committee are available on the website of the Institute under the head 'Resources'.
5.	Opinions can be obtained from EAC as per its Advisory Service Rules which are available on the website of the ICAI, under the head 'Resources'. For further information, write to eac@icai.in.