WIRC Seminar - AS 16 Borrowing Costs and AS 13 Accounting for Investments

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Summary

- Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds.
- If, and only if, an asset meets the definition of a qualifying asset then borrowing costs incurred are capitalised as part of its cost (unless a scope exception applies).
- A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
- The core principle of the standard is that only those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised.
- All other borrowing costs are expensed as incurred.
- Borrowing costs that satisfy the 'directly attributable' criterion are generally those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. Borrowing costs are not always readily attributable to a qualifying asset. This may be the case where an entity borrows funds generally. AS 16 includes guidance on how to allocate borrowing costs in such circumstances.

Summary

- An entity begins to capitalise borrowing costs on the commencement date which is when three conditions are met:
- a) it incurs expenditures for the asset;
- b) it incurs borrowing costs for the asset; and
- c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.
- An entity suspends capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.
- An entity ceases to capitalise borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Is the 'cost of equity' such as, for example, dividends within the scope of AS 16

- No. The standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

Substantial period of time

- 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.

Can internally developed intangible assets be a qualifying asset?

- Yes. AS 16 does not exclude internally developed intangible assets from the definition of a qualifying asset.
- An example of a qualifying intangible asset could be internally developed software produced over a substantial period of time.

Example: Qualifying Asset

- A property developer acquires a property, which management intends to develop into luxury apartments.
- Alternatively, the property could be sold or leased immediately after its acquisition. Should management's intention be taken into account?

- **Response:**
- Yes. Assessing whether an asset is a qualifying asset takes into consideration its intended use.
- The property is determined to be a qualifying asset because management intends to develop the asset over a substantial period of time.
- This is not changed by the fact that the property could alternatively be sold immediately.

Inventories that are routinely manufactured / produced in large quantities on a repetitive basis over a short period of time

Example

- Some food and drink products require a substantial period of time to get ready for use or sale, because they require ripening/maturation. Does the exemption apply for such assets?

Response

- Examples of food and drink products that can require a substantial period of time include cheese, wine and whisky.
- Such assets may qualify under the exemption. However, management must demonstrate in each case that inventories are being produced in large quantities on a repetitive basis (AS 16.5).
- Where these conditions are satisfied, the entity has an accounting policy choice of whether or not to capitalise borrowing costs.

Are Funds not Fungible for the Purpose of Capitalising Borrowing Cost?

Example

- A Ltd. has raised specifically borrowed Rs 100 crore for funding its project/ qualifying asset. After the completion of the project, the outstanding loan balance is Rs 60 crore.
- The company now starts construction of another project /qualifying asset. It has general borrowing of Rs 40 crore.
- It does not prepay the old loan because it carried a lower rate of interest as compared to current market interest. A question arises on whether the balance loan of Rs 60 crore should be also considered as general borrowing and capitalisation of interest cost for the new project.
- The company would contend that money is fungible and if it repays the old loan borrowed specifically for the first completed project, it would have incrementally incurred higher interest.

Specific Cost of Borrowing

Example

- An entity has issued a loan for the construction of a specific qualifying asset. The full amount is not needed immediately for expenditures on the qualifying asset and part of the proceeds are temporarily re-invested in a cash deposit. Should the entity reflect the investment income in the amount of borrowing costs to be capitalised?

Response

- Yes. AS 16 requires eligible borrowing costs to be measured as actual borrowing costs on the specific borrowing less any investment income earned on the temporary investment of the specifically borrowed funds.
- Where the excess funds are invested temporarily investment income is deducted from the actual borrowing costs.

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Foreign exchange borrowing

- AS 16 states that borrowing costs may include exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs.
- The standard offers no detailed guidance on how to interpret this.
- Accordingly, entities should develop their own detailed policy.
- As with any other accounting policy, the chosen method should be applied consistently and disclosed if significant

Group Scenario

Example

- A group consists of the parent P and two subsidiaries, A and B. A is engaged in the construction of a business park with funding being provided by B which charges intra-group interest at a market rate.
- The parent P and subsidiary B are cash-rich, and the group as a whole has no external borrowings.
- Can the finance costs on the borrowings be capitalised in the individual financial statements of A or B?

Response

- In this situation A must capitalise interest, as it has both a qualifying asset (the construction of the business park) and borrowing costs (the intra-group interest charged by B).
- At individual company level, it is irrelevant that A's borrowings are intra-group.

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AS 13 Accounting for Investments

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

A long term investment is an investment other than a current investment.

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.

AS 13 Accounting for Investments

An enterprise should disclose current investments and long term investments distinctly in its financial statements.

Further classification of current and long-term investments should be as specified in the statute governing the enterprise. In the absence of a statutory requirement, such further classification should disclose, where applicable, investments in:

- (a) Government or Trust securities
- (b) Shares, debentures or bonds
- (c) Investment properties
- (d) Others—specifying nature.

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If an investment is acquired, or partly acquired, by the issue of shares or other securities, the acquisition cost should be the fair value of the securities issued (which in appropriate cases may be indicated by the issue price as determined by statutory authorities).

The fair value may not necessarily be equal to the nominal or par value of the securities issued.

If an investment is acquired in exchange for another asset, the acquisition cost of the investment should be determined by reference to the fair value of the asset given up. Alternatively, the acquisition cost of the investment may be determined with reference to the fair value of the investment acquired if it is more clearly evident.

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.

Can due diligence cost be capitalised under AS 13?

- The investment decisions are generally preceded by significant costs incurred for due diligence of the entity that is being acquired. Due diligence may be a very critical element of investment acquisition.
- The ICAI's Expert Advisory Committee (EAC) has been in the past asked to opine on the treatment of due diligence cost incurred for acquiring investment/business.
- The EAC noted paragraph 9 of Accounting Standard (AS) 13, 'Accounting for Investments', which states that "the cost of an investment includes acquisition charges such as brokerage, fees and duties".
- Keeping in view the nature of the items of acquisition charges mentioned in AS 13, the EAC took the view that the cost of acquisition should include only those direct charges which are incurred 'on' acquisition of investment, i.e., the expenses, without the incurrence of which, the transaction could not have taken place such as share transfer fees, stamp duty, registration fees, and duties and levies by regulatory agencies and stock exchanges.
- The expenses incurred 'before' the acquisition, even though directly attributable to acquisition should not be added to the cost of acquisition of shares as these do not represent the worth of the shares acquired.

Other than temporary impairment

- A buys 250,000 of the equity securities of Currency Bank. A national liquidity crisis causes a downturn in Currency's business, so a major credit rating agency lowers its rating for the bank's securities. These events cause the quoted price of A's holdings to decline by 50,000. The CFO of A believes that the liquidity crisis will end soon, resulting in a rebound of the fortunes of Currency Bank, and so authorizes the recordation of the 50,000 valuation decline.
- Investments held primarily to protect, facilitate or further existing business or trading relations, often called trade investments, are not made with the intention that they will be available as additional cash resources and are thus classified as long-term.
- Other investments, such as investment properties, are intended to be held for a number of years to generate rental income and capital appreciation.
- They are, therefore, classified as long-term assets even though they may be marketable.

Other than temporary impairment

- A bank may hold shares in a leasing company for strategic reasons in which case the investment would be long-term.
- The fact that a marketable investment has been retained for a considerable period does not necessarily preclude its classification as current.
- Although many enterprises may not intend to realise their assets in current operations, they usually regard many of their investments as being available for the purposes of their current operations particularly where the intention is to make investment when there are surplus funds and sell them when funds are in short supply.
- Every enterprise should analyse their investments and attribute carrying amounts to them according to whether their characteristics are those of current investments or long-term investments.
- It is likely in the absence of any specific guidelines on this issue in AS-13, different companies in India may be following different practices, leading to non-comparability of financial statements. In brief, whether an investment is long-term or current will depend on facts and circumstances of each case and judgement based on the above broad criteria.

THANK YOU