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IAS® Standard 23 Borrowing Costs

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CASE STUDY - IAS 23 BORROWING COSTS

Introduction

Calculating and capitalizing borrowing costs in qualifying assets is an ongoing activity throughout the construction/production process. Borrowing for the construction or production process may be directly related to the qualifying asset, or some (or all) of the construction or production cost may be financed from other general borrowings. In addition, expenditures financed by borrowing costs are not realized in one time and are not evenly distributed throughout the construction period. Also, long-term construction and production activities may be suspended for various reasons.

In this case, the aim is to provide an understanding of how borrowing costs are accounted for during a long-term construction period, by associating them with the construction process.

The Case Information

Yellow Co. management had decided to build a new warehouse at the beginning of 2020 as part of their plan to increase the effectiveness of their supply chain. The construction of the warehouse started in early November 2020 and was finished at the end of December 2021. A total of CU700,000 was spent on the construction of the warehouse and the warehouse was recognized at the beginning of August at a cost of CU700,000. However, at the end of 2021, the auditors who came for the audit of the entity informed the management that the recognized cost of the warehouse was not correct as a result of their evaluation and that this error should be corrected. The entity management responded to this request by stating that their calculations were correct. Auditors, on the other hand, stated in their evaluation that the construction of the warehouse is a qualifying asset and related borrowing costs should be capitalized. The management and auditors decided to make a study on detailed information about the warehouse construction in order to make an accurate assessment.

The construction of the warehouse started on November 1, 2020 and ended on December 31, 2021. Warehouse construction stopped between February 1, 2021 and April 1, 2021 due to workers' strike. The following expenditures were made during the construction.

Months	**2020**	**2021**
January, 1		40,000
February, 1		
March, 1		
April, 1		210,000
May, 1		
June, 1		90,000
July, 1		
August, 1		150,000
September, 1		
October, 1		
November, 1	120,000	60,000
December, 1	30,000	
Total	**150,000**	**550,000**

Yellow Co. has the following debts outstanding at January 1, 2020 through December 31, 2021.

- %14, 4 year note, CU 12,000,000. Interest is paid annually at December, 31.
- %11, 5 year note, CU 8,000,000. Interest is paid annually at December, 31.

Yellow Co. furthermore, on December 31, 2020, borrowed CU200,000 loan with 10% interest payable annually to be used in the construction of this warehouse. Interest expense on this particular loan in 2021 was CU20,000. In 2021, the entity used this loan for temporary investments, generating a total income of CU2,000.

Discussion Questions

a) Is it correct to recognize the total of the expenditures made for the warehouse as the cost of this warehouse?

b) How long do you think the construction of this warehouse lasted? Should interest expense for the period February 1-April 1 2021 be capitalized?

c) What should be the values of the warehouse in the statement of financial position dated December 31, 2020 and December 31, 2021?

SOLUTION OF CASE STUDY- IAS 23 BORROWING COSTS

a) In addition to the production costs of the warehouse, the entity should include the financial expenses incurred due to the financing of the warehouse construction in the cost of the warehouse. The construction of this warehouse requires substantial time to make it suitable for the intended use. Therefore, the warehouse meets the definition of qualifying asset.

b) There are 14 months between the start of the construction of the warehouse and its completion. However, the construction of the warehouse was suspended for 2 months due to the workers' strike. Due to this suspension, financing expenses should be capitalized over 12 months, not 14 months.

c) The entity used general and specific borrowings to finance the warehouse construction. While general borrowings are valid for both years, specific borrowings are only made for 2021. The capitalisation rate of general borrowings will be valid in both years.

Calculation of capitalisation rate

Loans	Outstanding from January 1, 2020 to December 2021	Weighted Average Loan	Rate	Borrowing Cost (Interest Expense)
14% Loan	CU12,000,000	CU12,000,000	14%	12,000,000*0.14=1,680,000
11% Loan	CU8,000,000	CU8,000,000	11%	8,000,000*0.11=880,000
TOTAL		CU20,000,000		CU2,560,000

Annual interest expense of these borrowings are CU 2,560,000. If there is no capitalisation of interest all amount will be reported as interest expense in 2020 profit or loss statement.

$$Capitalisation\ Rate = \frac{2{,}560{,}000}{20{,}000{,}000} x100 = 12.8\%$$

For expenditures financed by general borrowing, the interest amount to be capitalized will be calculated at a rate of 12.8%.

Expenditure made in 2020	Nominal Amount	Expenditure funded by the special borrowing	Expenditure funded by general borrowings	Months till the year end after expenditure	Weighted average amount of expenditure
November 1	120,000	0	120,000	2	120,000*2/12=20,000
December 1	30,000	0	30,000	1	30,000*1/12=2,500
	CU150,000	0	CU150,000		CU22,500

Weighted amount of expenditures funded by general borrowings is CU 22,500. The capitalised interest for the year 2020 is:

Borrowing Cost eligible for capitalisation from general borrowings: CU 22,500 * 12,8 % = 2,880

Expenditure made in 2021	Nominal Amount	Expenditure funded by the special borrowing	Expenditure funded by general borrowings	Months till the year end after expenditure	Weighted average amount of expenditure
January 1	40,000	40,000	0	12	0*12/12=0
April 1	210,000	160,000	50,000	9	50,000*9/12=37,500
June 1	90,000		90,000	7	90,000*7/12=52,500
August 1	150,000	-	150,000	5	150,000*5/12=62,500
November 1	60,000	-	60,000	2	60,000*2/12=10,000
	CU550,000	CU200,000	CU350,000		CU162,500

Borrowing Cost eligible for capitalisation from general borrowings: CU162,500 * 12,8 % = 20,800

Borrowing Cost eligible for capitalisation from specific borrowings:

CU200,000 * 10 % = 20,000 Annual interest

Under normal circumstances, the interest expense that the entity would capitalize would be CU40,800, which is the sum of CU20,800 and CU20,000. However, there are two situations here. First, CU2,000, the investment income from the specific borrowing, must be offset against the interest expense of the specific borrowing. Second, the capitalization of interest expenses during the suspension period should be stopped. The interest expense of this period is (this period is financed by specific borrowing);

$$= \frac{20{,}000}{12} x2\ months = CU\ 3{,}333\ (rounded)$$

Then the net interest expense should be capitalised from specific borrowing is;

Annual Interest expense from specific borrowing	20,000
Investment income	(2,000)
Suspension period	(3,333)
Borrowing cost to be capitalised from specific borrowing	14,667

Values of the warehouse in the statement of financial position dated December 31, 2020 and December 31, 2021

	31.12.2020	31.12.2021
Beginning Value		152,880
Total expenditure	150,000	550,000
Capitalised interest from general borrowings	2,880	20,800
Capitalised interest from specific borrowings	-	14,667
Final Value	**152,880**	**738,347**