AS 16 = BORROWING COSTS

CHAPTER 13

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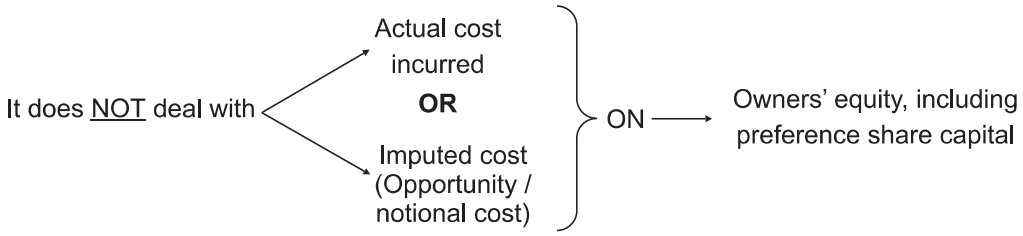
1. Objective

This Standard discusses about the accounting treatment for borrowing costs i.e. whether the borrowing costs should be capitalised along with the assets **OR** charged to profit and loss statement.

2. Scope

This standard deals with **only** borrowing costs.



It means the standard does NOT deal with dividend accounting as dividend paid is not treated as borrowing cost.

Note: If preference share capital is treated as borrowing – preference dividend is considered as borrowing cost.

3. Definitions

Borrowing costs are interest and other costs incurred in connection with the borrowing of funds;

Borrowing costs may ***include*** the following:

(a) Interest and commitment charges on bank borrowings and other short-term **and** long-term borrowings;

(b) Amortisation of discounts or premium; (i.e. Discount on issue of debentures (borrowings) **or** Premium payable on redemption of debentures/other borrowings);

(c) Amortisation of ancillary costs incurred for arrangement of borrowings; (NOT for closing a borrowing);

(d) Finance charges in respect of assets acquired under finance leases or under other similar arrangements; and (explained at the end of the chapter)

(e) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. (explained at the end of the chapter)

Concept capsule 1

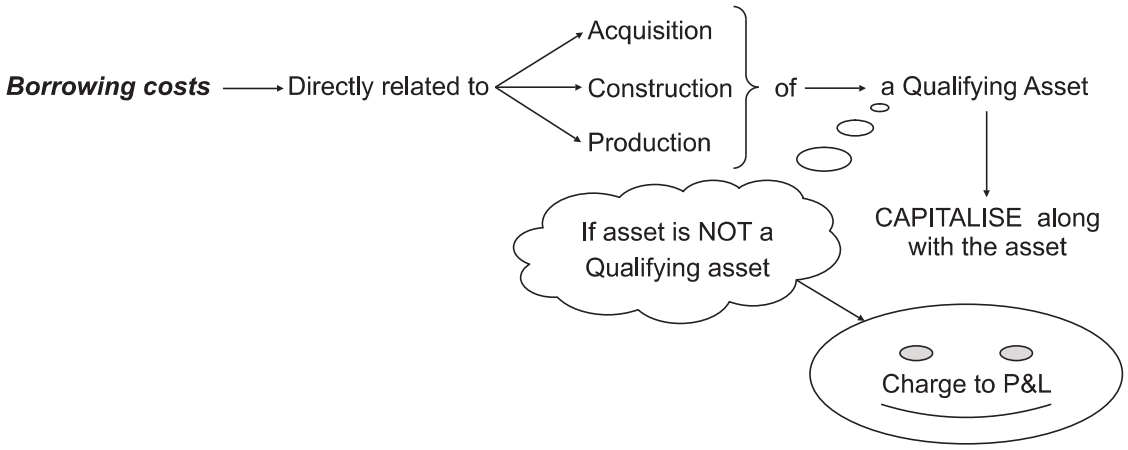
Raji Ltd. took a loan on 1-4-2013 and as per the terms of the agreement it should repay on 31-3-2018. During 2015, it sold one of its divisions and with the sale proceeds it repaid the loan on 30-6-2015. The company paid ₹50,000 to bank as prepayment fee. Can this charge of ₹50,000 be treated as borrowing costs? Explain with reasons.

Suggested Answer

As per AS 16, any ancillary costs incurred for arrangement of borrowings is treated as borrowing cost. The prepayment fee is incurred for extinguishment of liability but not for arrangement. Hence it is not a borrowing cost and AS 16 is not applicable.

Such charges should be charged to P&L in the year in which it is incurred. (Should NOT be deferred)

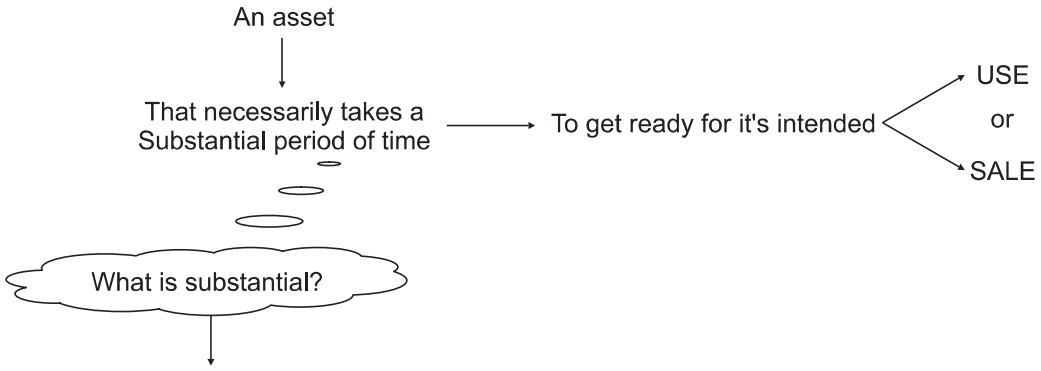
4. Recognition



Borrowing costs can be capitalised only when (Asset recognition conditions)

1. There are probable future economic benefits inflow; and
2. Borrowing costs can be measured reliably.

What is a '**Qualifying asset**'?



- ❖ Primarily depends on the facts and circumstances of each case;
- ❖ Generally it is 12 months;
- ❖ It can be shorter than 12 months – ***if justifiable***;

As per the definition –

An asset which is intended for use (i.e. for producing goods *or* providing services *or* for earning income) – so the asset can be a fixed asset **or** investments; E.g. Construction of building, manufacturing plants, power generation facilities, dams, ship building, etc.

(**OR**)

An asset is intended for sale – so it can be inventory ***i.e.*** if the *inventory is a qualifying asset*, borrowing costs should be included in the cost of inventory; E.g. inventory like '*wine*', '*genetic seeds*', etc as these take substantial period of time to make it ready for sale.

Concept capsule 2

Raji Ltd. purchased a car and the company borrowed funds for its acquisition. Can the company capitalise the interest paid on such borrowing?

Suggested Answer

As per AS 16, borrowing costs which are directly related to acquisition, construction or production of a qualifying asset should be capitalised along with the asset and a qualifying asset is the one which takes substantial period of time for making it ready for use or sale.

In the given case, Car is an asset, it can be used immediately after acquisition and acquisition doesn't take substantial period of time, hence car is NOT a qualifying asset; So interest incurred should **not** be capitalised and it should be charged to P&L for the period incurred.

5. Period of capitalisation

The standard has given guidance on the following points:

1. When to **start** capitalisation;
2. When to **suspend**; and
3. When to **stop**.

6. Commencement of capitalisation

Capitalisation of borrowing costs should commence when **ALL** of the following conditions are satisfied:

(a) Expenditure on qualifying asset being incurred;

(b) Borrowing costs are being incurred; and

(c) Activities are in progress. (which are necessary to make the asset for its intended use or sale)

Which activities should be in progress? (Necessary to make the asset for its intended use or sale)

These activities include

- ❖ The physical construction of the asset;
- ❖ Technical and administrative work prior to the commencement of physical construction i.e. obtaining permits for construction from local authorities, designing, etc.

When necessary activities are NOT in progress, the interest incurred during that period should be charged to P&L statement.

Concept capsule 3

Aruna Ltd. purchased a land on 1-4-2017 for constructing a building. The entity took a loan of ₹50 lakh @ 12% p.a. from State Bank of India for construction on the same date. The construction work started from 30-9-2017, during this period no work took place at the site. The accountant capitalised the total interest incurred during the year (50 × 12% = ₹6 lakh) to the building. Is this treatment in accordance with AS 16?

Suggested Answer

As per AS 16, capitalisation of borrowing costs should commence when it satisfies the said three conditions above.

In the given case, construction of building is a Qualifying asset; and

For the first six months (1-4-2017 to 30-9-2017)

NO expenditure is incurred on construction of building and NO activities are in progress during the period. As the conditions specified in the Standard are not satisfied in the first six months, ₹3 lakh (50 × 12% × 6/12) of interest incurred should be charged to P&L.

For the next six months (1-10-2017 to 31-3-2018)

As all the conditions are satisfied during this period, Interest of ₹3 lakh should be capitalised along with the building.

Concept capsule 4

Lakshmi Ltd. purchased a land on 1-4-2017 for constructing a building. The entity borrowed ₹50 lakh @ 12% p.a. from State Bank of India for construction of a building on the same date. The company started the construction work from 30-06-2017. It took three months (Apr, May & Jun) to get the approval of local municipal authority. From when can the company start capitalisation of interest as per AS 16?

Suggested Answer

As per AS 16, capitalisation of borrowing costs should commence when it satisfies the said three conditions above.

In the given case, the company incurred expenditure on a qualifying asset (land cost), it incurred borrowing cost and the necessary activities for making the asset ready for use or sale i.e. planning and approval from local municipal authorities are in progress. As the above conditions are satisfied, the company can start capitalisation of interest from 1-4-2017.

7. Suspension of capitalisation

Capitalisation of borrowing costs should be suspended (pause/stop temporarily) when there is NO active development **or** active development is interrupted.

- When substantial technical and administrative work is being carried out, capitalisation should NOT be suspended.
- If there is any ***temporary delay*** during construction or production ***for making the asset ready*** for its intended use or sale – interest incurred in that period should NOT be suspended.

Concept capsule 5

In producing genetically modified seeds, the seeds should be exposed to right climate for maturing and it should be stored in-house for some months. Can the entity capitalise the borrowing costs incurred during this period with the seeds (inventory)?

Suggested Answer

The activities in progress are necessary to make the goods ready for sale hence the borrowing costs incurred during this period should be added to cost of inventory i.e. it should NOT be suspended.

Concept capsule 6

Navya Ltd. is constructing a building. Due to labour strike it stopped the construction for 15 days. Can the company capitalise the interest incurred during the 15 days?

Suggested Answer

As per AS 16, Capitalisation of borrowing costs should be suspended when there is NO active development or active development is interrupted.

In the given case, there is no active development and this delay is not related for making asset ready for its use or sale. Hence the interest incurred during the period should be charged to P&L.

Concept capsule 7

Harsha Ltd. is constructing a bridge on a river in Maharashtra. The river having high water levels is common in that period. The construction is generally stopped when the water crosses a certain level. Can the company capitalise the interest cost incurred during the delayed period?

Suggested Answer

As per AS 16, Capitalisation of borrowing costs should be suspended when there is NO active development or active development is interrupted.

If such delays are common during the construction period in that geographic region, it can be treated as necessary for construction; hence capitalisation continues and NO need to suspend capitalisation of interest.

8. Cessation of Capitalisation

Capitalisation of borrowing costs should be stopped when ***substantially all*** necessary activities are complete i.e. the asset is ready for its intended use or sale.

Even though routine administrative work might still exist it can be treated as substantially complete. If minor modifications, like the decoration etc. are pending, it can be considered as substantially completed.

When a qualifying asset is **completed in parts** i.e. the asset can be divided into parts – Capitalisation of borrowing costs should be stopped when any completed part is capable of being used while construction continues for the other parts.

Concept capsule 8

Yeswanth Ltd. is constructing a five floored building at Bangalore for administrative office. The company started using the premises once the first floor was completed. The accountant of the company capitalised the interest related to first floor even after it is being used and as per his opinion, interest should be capitalised till the date of completion of all floors. Is this accounting treatment correct as per AS 16?

Suggested Answer

As per AS 16, when a qualifying asset is completed in parts, capitalisation of borrowing costs should be stopped when any completed part is capable of being used while construction continues for the other parts.

In the given case, the first floor is completed and is being used by the company hence the capitalisation of borrowing costs with respect to the first floor should be stopped. As the other floors are under construction, interest capitalisation with respect to the other floors should be continued.

Concept capsule 9

Manasa Cements Ltd. is constructing a cement plant involving three processes which are carried out in a sequence at different parts of the plant within the same site. One of the processes is complete by 31st March, 2012. The cement plant can be ready to use only when construction of all the processes are complete. The company started charging the interest to P&L from 1st April, 2012. Is the accounting treatment correct as per AS 16?

Suggested Answer

Even though one process is complete the plant cannot be used for its intended purpose and it requires completion of all processes. Hence interest portion of the completed process should be capitalised till the date the entire plant is ready to use. The accounting treatment followed by the company is NOT in compliance with AS 16.

How much amount should be capitalised?

Identification of direct relationship between particular borrowing and a qualifying asset is difficult. Involvement of professional judgement is required.

9. If funds are specifically borrowed for obtaining a qualifying asset

In this case an entity should capitalise the following amount:

Actual borrowing costs incurred on borrowing during the period	XXX
***Less**: Any income on the temporary investments of the borrowed amount*	XX
Amount to be capitalised	**XXX**

When funds are borrowed and not useful for immediate purposes, entities often invest the funds temporarily. The income from such investments should be deducted from the borrowing costs incurred and the balance amount should be capitalised.

Concept capsule 10

Gayatri Ltd. is constructing a building at Hyderabad from 1-4-2017. The estimated expenditure is ₹20 crore. It took a loan on 1-10-2017 for ₹15 crore @ 10% p.a. from SBI specifically for the construction and the balance amount is funded from retained earnings. It invested the excess funds temporarily in fixed deposits and it earned an amount of ₹5 lakh. Building is under construction till 31-3-2018. What is the amount to be capitalised as per AS 16?

Suggested Answer

- Construction of building is a qualifying asset as it is taking more than 12 months for making it ready for use or sale.
- The funds are specifically borrowed for the purpose of obtaining a qualifying asset.
- Actual borrowing costs incurred are ₹75 lakh (₹15 crore × 10% × 6/12).
- Amount to be capitalised on specific borrowings is after deducting any income earned on temporary investments of borrowings. Hence ₹70 lakh (₹75 – 5 lakh) should be capitalised along with the building cost.

Concept capsule 11

On 20.4.2017, Srinivas Ltd. obtained a loan from the Bank for ₹50 lakh to be utilised as under:

	₹In lakhs
Construction of a shed (Started on 1-4-2017)	20
Purchase of machinery	15
Working capital	10
Advance for purchase of truck	5
Total	**50**

In March, 2018, construction of the shed was completed and machinery installed. Truck was not delivered by the supplier. Total interest charged by the bank for the year ending 31.3.2018 was ₹9 lakh. Show the treatment of interest under AS 16. (***IPCC May 2014, 2011, May 2010, PCC May 2011***)

Suggested Answer

As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized. A qualifying asset is an asset that necessarily takes a substantial period of time (usually 12 months or more) to get ready for its intended use or sale. If an asset is **ready** for use or sale at the time of acquisition then it is not a qualifying asset and interest incurred on that should be charged to P&L.

In the given case, construction of a shed can be considered as a qualifying asset as it is taking a substantial period of time to make it ready for use or sale. The other assets are ready to use at the time of acquisition hence they cannot be treated as qualifying assets.

Treatment of interest as per AS 16

	Particulars	Nature	Interest to be capitalized (lakhs)	Interest to be charged to P&L (₹In lakhs)
(1)	Construction of a shed	Qualifying asset	₹ 9 lakh × Rs. 20 lakh / Rs. 50 lakh = ₹3.60	
(2)	Purchase of machinery	Not a quailfying asset		₹ 9 lakh × ₹ 15 lakh / ₹ 50 lakh = ₹2.70
(3)	Working capital	Not qualifying asset		₹ 9 lakh × ₹ 10 lakh / ₹ 50 lakh = ₹1.80
(4)	Advance for purchase of truck	Not a qualifying asset		₹ 9 lakh × ₹ 5 lakh / ₹ 50 lakh = ₹0.90
	Total		**₹ 3.60**	**₹ 5.40**

Concept capsule 12

A company borrowed ₹40 lakh for purchase of machinery on 1.4.2017. Interest on loan is 9% p.a. The machinery was ready to use from 1.3.2018. Pass journal entries for the year ended 31.3.2018 to record the borrowing cost of loan as per AS 16. ***(IPCC - May, 2008 modified)***

Suggested Answer

The machinery installation is taking a substantial period of time (11 months – can be considered as substantial period) to make it ready for use, hence it is a qualifying asset and interest incurred till the date of ready to use should be capitalised along with the machine and interest incurred from the date of ready to use should be charged to P&L.

Interest incurred up to 31.3.2018 (40,00,000 × 9%) (12 months)	=	3,60,000
Less: Interest to be capitalised till the date of ready to use		
i.e. for 11 months period 3,60,000 × 11/12 months	=	3,30,000
Amount to be charged to P&L A/c	=	30,000

Journal Entry

Machinery a/c	Dr.	3,30,000	
Interest expense a/c	Dr.	30,000	
To Interest payable / bank a/c			3,60,000
(Being interest payable on loan till the date of ready to use is capitalised and the balance is charged to P&L a/c)			
Profit and Loss A/c	Dr.	30,000	
To Interest expense a/c			30,000
(Being Interest expense transferred to P&L statement)			

10. If funds are borrowed generally and used for obtaining a qualifying asset

The following steps help us to determine the amount to be capitalised:

- ❖ Entity should determine the capitalisation rate;

- Capitalisation rate is ***weighted average borrowing rate of ONLY general borrowings*** outstanding during the period i.e. specific borrowings should NOT be considered for calculation of capitalisation rate;

- Formula for Capitalisation rate = $\frac{\text{Average borrowing costs incurred during the year}}{\text{Aggregate outstanding borrowings}} \times 100$

- Aggregate of outstanding borrowings = Amount of borrowing × Number of months outstanding/12 months

- Interest to be capitalised = Expenditure incurred on the asset × capitalisation rate × period of construction/12;

Caution: Total capitalised amount should NOT exceed the actual borrowing costs incurred during the period.

Concept capsule 13

Padma Ltd. is constructing a plant and the expenditure incurred till 31-3-2018 is ₹50 lakh. The following are the general borrowings as on 31-3-2018:

	₹In lakhs
10% Debentures	80
12% Bank loan	20
9% Public deposits	50
Total borrowings	**150**

The accountant of the company has not capitalised any interest as there are no specific borrowings for plant. Is he correct? If No, how much amount should be capitalised?

Suggested answer

When the funds are borrowed generally and used for obtaining a qualifying asset – the company should apply capitalisation rate (i.e. weighted average borrowing rate) on the expenditure incurred on the asset. Let us calculate the weighted average borrowing rate.

Loan	Calculation	Interest incurred (₹Lakh)
10% Debentures	80 × 10%	8.00
12% Bank loan	20 × 12%	2.40
9% Public deposits	50 × 9%	4.50
Total interest incurred		**14.90**

$$\text{Weighted average borrowing rate} = \frac{\text{Average borrowing costs incurred during the year}}{\text{Aggregate outstanding borrowings}} \times 100$$

$$= \frac{14.90}{150} \times 100 = 9.33\%$$

Interest to be capitalised = Expenditure of the asset × capitalisation rate × period of construction/12

= 50 lakh × 9.33% × 12/12 = ₹4.665 lakh

Interest to be charged to P&L = 14.90 – 4.665 = 10.235 lakh

Concept capsule 14

Can an entity include *working capital loan* also under general borrowings? Discuss.

Suggested Answer

As per AS 16, borrowing costs include interest and commitment charges on bank borrowings and other short-term and long-term borrowings. It can include the working capital loan under general borrowings for calculation of capitalisation rate of interest.

11. Excess of the Carrying Amount of the Qualifying Asset over Recoverable Amount

When the carrying amount of qualifying asset after capitalisation of interest **exceeds** its recoverable amount **or** net realisable value (NRV), the carrying amount is written off as per other Accounting Standards.

If the qualifying asset is a fixed asset or investment – AS 28 is applicable to write off excess carrying amount.

If the qualifying asset is inventory – AS 2 is applicable to write off excess carrying amount.

12. Disclosures

The entity should disclose the following in its financial statements:

(a) The accounting policy adopted for borrowing costs; **and**

(b) The amount of borrowing costs capitalised during the period.

Explanation on: (Read this concept only after reading AS 11)

Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. (*Little advanced level – but try - you will get it*)

Exchange fluctuation differences (applies only when there is LOSS on fluctuation) arising from foreign currency borrowings are charged to P&L statement as per AS 11 and out of such fluctuation charge, some portion will be treated as borrowing costs as per this Standard subject to conditions.

1. Entity should compute the borrowing costs as if it had borrowed the funds in India.
2. It has to compute the actual borrowing cost incurred from foreign currency borrowings.
3. The difference between points 1 & 2 should be considered as borrowing cost *but it cannot exceed* the fluctuation difference.

This point can be understood better with the following example – Go through carefully:—

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 2017, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 2017, the exchange rate between the currencies was ₹45 per USD. The exchange rate is ₹48 per $ as at March 31, 2018. The corresponding amount (i.e. 10,000$ × 45 = ₹4,50,000) could have been borrowed by the company in India at 11% p.a. as on April 1, 2017.

(***IPCC Nov. 2013 & 2015***)

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = $ 10,000 × 5% × ₹48 = ₹24,000

(ii) Exchange fluctuation loss on principal amount = $10,000 × (48 – 45) = ₹30,000 (As loan is a monetary item, it requires restatement as on balance sheet date as per AS 11)

(iii) Interest that would have resulted if the loan was taken in India = ₹4,50,000 × 11% = ₹49,500

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹49,500 – ₹24,000 = ₹25,500

Therefore, out of ₹30,000 foreign exchange fluctuation loss towards principal amount, only ₹25,500 will be considered as the borrowing cost and if such borrowing is related to obtain a qualifying asset it should be capitalised along with the asset, otherwise it should be charged to P&L.

So, the total borrowing costs for the company = ₹49,500 (₹24,000 + ₹25,500);

Out of ₹30,000 of foreign exchange fluctuation loss ₹25,500 is treated as borrowing cost under AS 16 and the balance of ₹4,500 should be charged to P&L as Forex fluctuation loss under AS 11.

Continuation to the above example:

If the interest rate on Indian borrowings is assumed to be 13% instead of 11% what would be your answer?

Answer

Indian currency borrowing costs = ₹4,50,000 × 13% = 58,500 and the difference between the Indian borrowing and foreign borrowing is ₹34,500 (₹58,500 – ₹24,000).

In this situation actual fluctuation loss is only ₹30,000. Hence the total amount of fluctuation loss should be treated as borrowing costs as per AS 16. So the total borrowing costs of the company is ₹54,000 (₹24,000 + ₹30,000) and NO charge for forex fluctuation loss as per AS 11.

Explanation to

Finance charges in respect of assets acquired under finance leases or under other similar arrangements: (Read this concept only after reading AS 19)

This situation arises only when a fixed asset is acquired under **finance lease** as per AS 19 and used for the purpose of a qualifying asset i.e. which takes substantial period of time to make it ready for its use or sale.

As per AS 19, minimum lease payments are divided between the repayment of principal amount and interest charges and interest charges should be charged to P&L statement. If the leased asset is a qualifying asset as per AS 16, such interest charges will be treated as borrowing cost and it can be capitalised along with the qualifying asset under this Standard.

Questions & Answers

Question No. 1

Enumerate two points which the financial statements should disclose in respect of Borrowing Costs as per AS 16. **(*PCC June 2009*)**

Answer

Refer '*disclosures*' of the above standard

Question No. 2

Briefly indicate the items which are included in the expression "Borrowing Cost" as per AS 16.

Answer

Refer 'definitions' of the above standard.

Question No. 3

An industry borrowed ₹40,00,000 for purchase of machinery on 1.6.2017. Interest on loan is 9% per annum. The machinery was put to use from 1.1.2018. Pass journal entry for the year ended 31.3.2008 to record the borrowing cost of loan as per AS 16. **(*PCC May 2008*)**

Answer

Interest up to 31.3.2018 (40,00,000 × 9% × 10/12 months)	3,00,000
Less: Interest relating to pre-operative period 3,00,000 × 7 × 10	2,10,000
Amount to be charged to P&L A/c	**90,000**
Pre-operative interest to be capitalized	2,10,000

Journal Entry

Machinery a/c Dr.	2,10,000	
To Loan a/c		2,10,000
(*Being interest on loan for pre-operative period capitalized*)		
Interest on loan a/c Dr.	90,000	
To Loan a/c		90,000
(*Being the interest on loan for the post-operative period*)		
Profit and Loss a/c Dr.	90,000	
To Interest on loan a/c		90,000
(*Being interest on loan transferred to P&L A/c*)		

Note: In this question 7 months' period is considered as a substantial period of time and accordingly interest incurred during the period is capitalised.

Question No. 4

On 1st April, 2017, Amazing Construction Ltd. obtained a loan of ₹32 crore to be utilized as under:

(i) Construction of sea link across two cities: ₹25 crore
(Work was held up totally for a month during the year due to high water levels)

(ii) Purchase of equipments and machineries: ₹3 crore

(iii) Working capital: ₹2 crore

(iv) Purchase of vehicles: ₹50,00,000

(v) Advance for tools/cranes etc.: ₹50,00,000

(vi) Purchase of technical know-how: ₹1 crore

(vii) Total interest charged by the bank for the year ending 31st March, 2018: ₹80,00,000

Show the treatment of interest by Amazing Construction Ltd. **(*IPCC – Nov. 2016 & 2010*)**

Answer

As per AS 16, qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use. 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. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

			Interest to be charged to P&L	
	Qualifying Asset	Interest to be capitalized		
Construction of sea-link	Yes	62,50,000		(80,00,000 × (25/32)
Purchase of equipments and machineries	No		7,50,000	(80,00,000 × (3/32)
Working capital	No		5,00,000	(80,00,000 × (2/32)
Purchase of vehicles	No		1,25,000	(80,00,000 × (.5/32)
Advance for tools, cranes etc.	No.		1,25,000	(80,00,000 × (.5/32)
Purchase of technical know-how	No		2,50,000	(80,00,000 × (1/32)
Total		**62,50,000**	**17,50,000**	

Question No. 5

In May, 2017, Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2018 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹18 lakh, whereas the total interest payable to the bank on the loan for the period till 31st March, 2018 amounted to ₹25 lakh. Can ₹25 lakh be treated as a part of the cost of the factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

Answer

AS 16 - clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building up to the date of completion (January, 2018) i.e. ₹18 lakh alone can be capitalized and the balance i.e. 7 lakh should be charged to P&L.

Question No. 6

Axe Limited began construction of a new plant on 1st April, 2017 and obtained a special loan of ₹4,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.