AS-16: BORROWING COSTS

Meaning	✓ These are the interest and other costs incurred by an enterprise in connection with the borrowing of funds.
Inclusions	✓ It includes the following : ❖ Interest & related charges on bank borrowings (short term & long term) ❖ amortisation of discounts or premiums relating to borrowings ❖ amortisation of ancillary costs incurred ❖ finance charges in respect of assets acquired under finance leases ❖ exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Capitalisation of Borrowing Costs
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.
Borrowing cost on any item other than the qualifying asset should be written off in the P&L A/c in the period in which they are incurred.
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
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. Step: Calculate Average Funds Expended / Weighted Avg. Exp. ⇒ Expenditure x Period Step: Calculate Capitalisation Amount (1) Use specific borrowing first for meeting Avg. Expenditure (2) Use General borrowings for meeting balance Expenditure Amount = Expenditure x Capitalisation Rate The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Qualifying Asset

Meaning	✓ A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
Substantial Period	✓ Substantial period of time depends on the facts & circumstances of each case. However, a period of 12 months may be considered a substantial period of time unless shorter/longer period is justified on the basis of facts & circumstances of case
Inclusions	✓ Following assets take >= 12 months to get ready to use : ❖ Assets that are constructed for own use of enterprise like manufacturing plants, power generation facilities,etc. ❖ Inventories where time is major factor to bring a change in their condition e.g. Liquor & Timber
Exclusions	✓ Assets that are ready for intended use when acquired are not qualifying asset.

Commencement of Capitalisation

The capitalisation of borrowing costs should commence when all the following conditions are satisfied:

→ expenditure for the acquisition, construction or production of a qualifying asset is being incurred

→ borrowing costs are being incurred

→ activities that are necessary to prepare the asset for its intended use or sale are in progress.

Suspension of Capitalisation

General Rule	✓ Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.
Exception	✓ Capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. ✓ When a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. *<u>For example</u> :Capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.*

Cessation of Capitalisation

→ Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

→ An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete

→ ***<u>Construction in Parts</u>*** : When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities of that part are complete.

Disclosure Requirements

The financial statements should disclose:

→ the accounting policy adopted for borrowing costs

→ the amount of borrowing costs capitalised during the period.

FOREIGN BORROWING

$\text{Enterprise} \xleftarrow{\text{Borrow}} \text{Foreign (USA)}$

$100000

When loan taken ER 1$ = ₹50

Year End ER 1$ = ₹55

Interest on foreign borrowing = 1000000 (Capitalised) (Given)

Exchange Difference (1L x 5) = 500000

	I	II	III
Interest on Local Borrowing (Notional)	1200000	1800000	900000
Exchange Difference:			
Considered as Borrowing cost [Capitalised : AS16]	12L-10L=2L	5L	Nil
Considered as Exchange Difference [P&L A/c : AS 11]	3L	Nil	5L
Total Amount capitalised	10L+2L = 12L	10L+5L = 15L	10L

Question 1

First Ltd. began construction of a new factory building on 1st April, 2019. It obtained Rs. 2,00,000 as a special loan to finance the construction of the factory building on 1st April, 2019 at an interest rate of 8% per annum. Further, expenditure on construction of the factory building was financed through other non-specific loans. Details of other outstanding non-specific loans were:

Amount	Rate of Interest p.a.
4,00,000	9%
5,00,000	12%
3,00,000	14%

The expenditures that were made on the factory building construction were as follows:

Date	Amount
1st April, 2019	3,00,000
31st May, 2019	2,40,000
1st July, 2019	4,00,000
31st December, 2019	3,60,000

The construction of factory building was completed by 31st March, 2020.
As per the provisions of AS 16, you are required to:

(1) Calculate the amount of interest to be capitalized.
(2) Pass Journal entry for capitalizing the cost and borrowing cost in respect of the factory building.

Solution

Computation of average accumulated expenses

3,00,000 x 12 / 12	3,00,000
2,40,000 x 10/ 12	2,00,000
4,00,000 x 9 / 12	3,00,000
3,60,000 x 3 / 12	90,000
	8,90,000

Calculation of average interest rate other than for specific borrowings

Amount of loan	Rate of Interest	Amount of interest
4,00,000	9%	36,000
5,00,000	12%	60,000
3,00,000	14%	42,000
12,00,000		**1,38,000**
Weighted average rate of interest {(1,38,000/ 12,00,000) x 100}		**11.50%**

Interest on average accumulated expenses

Specific borrowings (Rs. 2,00,000 x 8%)	16,000
Non-specific borrowings (Rs. 6,90,000* x 11.50%)	79,350
Amount of interest to be capitalized	95,350

*(Rs. 8,90,000 – Rs. 2,00,000)

Total expenses to be capitalized for building

Cost of building Rs. (3,00,000+2,40,000+4,00,000+3,60,000)	13,00,000
Add: Amount of interest to be capitalized	95,350
	13,95,350

Journal Entry

Date	Particulars	L.F.	Dr.	Cr.
31.03.2020	Building account Dr.		13,95,350	
	To Building WIP A/c*			13,00,000

	To Borrowing Costs A/c			95,350
	(Being amount of cost of building and borrowing cost thereon capitalized)			

*Considering that Rs. 13,00,000 was debited to Building WIP A/c earlier.

Question 2

Superbright Ltd. issued 10% secured debentures of Rs. 25 Lakhs on 30.06.2019. These debentures have floating charge on fixed assets. Money raised from debentures to be utilized as under:

Particulars	**Amount (Rs. in lakhs)**
Construction of factory building	8
Purchase of Machinery	10
Working Capital	7

Additional information
(i) Interest on debentures for the year 2019-20 was paid by the company.
(ii) In March 2020, machinery was installed and ready for its intended use.
(iii) During the year the company had invested idle fund of Rs. 4 lakhs (out of money raised from debentures) in banks' fixed deposit and had earned an interest of Rs. 24,000.
(iv) Construction of the factory building was completed after July 2020.

Show the treatment of interest under Accounting Standard 16 and also explain nature of assets.

Solution

Total interest on debentures for financial year ended 31.03.2020 was 1,87,500 (25 lakh x 10% x 9/12)
Total interest earned on FD was 24,000
Thus, eligible borrowing cost = Rs. 1,87,500 – Rs. 24,000 = Rs. 1,63,500

Particulars	**Nature of assets**	**Interest to be Capitalized**	**Interest to be charged to P&L Account**
Construction of factory building	Qualifying Asset*	1,63,500x8/25 = 52,320	Nil
Purchase of Machinery	Not a Qualifying Asset	Nil	1,63,500x10/25 = 65,400
Working Capital	Not a Qualifying Asset	Nil	1,63,500 x7/25 = 45,780
		52,320	**1,11,680**

As per AS 16, assets have been defined as 'qualifying asset' and 'non-qualifying asset'.

a) Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,
b) Non-qualifying asset is an asset which is ready for its intended use or sale at the time of its acquisition.
c) It is assumed that the machinery being a non qualifying asset in this case, hence the interest cost would not be capitalized as it was ready for its intended use at the time of its acquisition
d) According to AS 16 "Borrowing Costs", 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.
e) Also AS 16 "Borrowing Costs" states that 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.

Question 3

M/s. Zen Bridge Construction Limited obtained a loan of Rs. 64 crores to be utilized as under:

S. No.	Particulars	Amount (in Rs.)
1.	Construction of Hill link road in Kedarnath:(work was held up totally for a month during the year due to heavy rain which are common in the geographic region involved)	50 crores
2.	Purchase of equipments and machineries	6 crores
3.	Working capital	4 crores
4.	Purchase of vehicles	1 crore
5.	Advance for tools/cranes etc	1 crore
6.	Purchase of technical know-how	2 crores
7.	Total interest charged by the bank for the year ending 31st March, 2020	1.60 crores

Show the treatment of interest according to Accounting Standard by M/s. Zen Bridge Construction Limited.

Solution

Treatment of Interest (Borrowing cost) as per AS 16 'Borrowing Costs'

Particulars	Whether Qualifying Asset	Interest to be capitalized	Interest to be charged to P&L A/c
Construction of Hillroad*	Yes	1,60,00,000*50/64= 1,25,00,000	
Purchase of equipments & machineries	No		1,60,00,000*6/64= 15,00,000
Working capital	No		1,60,00,000*4/64= 10,00,000
Purchase of vehicles	No		1,60,00,000*1/64= 2,50,000
Advance for tools/cranes etc	No		1,60,00,000*1/64= 2,50,000
Purchase of technical know-how	No		1,60,00,000*2/64= 5,00,000
		1,25,00,000	**35,00,000**

Notes:

As per AS 16, assets have been defined as 'qualifying asset' and 'non-qualifying asset'.

a) Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale; whereas,

b) Non-qualifying asset is an asset which is ready for its intended use or sale at the time of its acquisition.

c) As per AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of qualifying assets should be capitalized as part of the cost of that asset. Other borrowing costs are recognized as expense in the period in which they are incurred. Capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

d) *It is assumed that construction of hill road will normally take more than a year (substantial period of time), hence considered as qualifying asset.

Question 4

In May, 2019, Capacity Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2020 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 Rs. 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2020 amounted to Rs. 25 lakhs. Can Rs. 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.

Solution

According to AS 16 'Borrowing Costs', capitalisation of borrowing costs should cease when substantially all the activities to prepare the qualifying asset for its intended use or sale are completed.
In the given case, since the qualifying asset was ready to use in January, 2020, therefore, interest till that date can only be capitalized. Hence, interest of Rs. 18 lakhs will only be capitalized. The balance of Rs. 7 lakhs (i.e. 25-18) will be debited to Profit and Loss Account.

Question 5

A company capitalizes interest cost of holding investments and adds to cost of investment every year, thereby understating interest cost in profit and loss account. Comment on the accounting treatment done by the company in context of the relevant AS.

Solution

Investments other than investment properties are not qualifying assets as per AS-16 Borrowing Costs. Therefore, interest cost of holding such investments cannot be capitalized. Further, even interest in respect of investment properties can only be capitalized if such properties meet the definition of qualifying asset, namely, that it necessarily takes a substantial period of time to get ready for its intended use or sale. Also, where the investment properties meet the definition of 'qualifying asset', for the capitalization of borrowing costs, the other requirements of the standard such as that borrowing costs should be directly attributable to the acquisition or construction of the investment property and suspension of capitalization have to be complied with.

Question 6

Rutu Builders Limited has borrowed a sum of US$ 20,00,000 at the beginning of Financial year 2019-20 for its residential project at LIBOR +3%. The interest is payable at the end of the financial year.
At the time of availment exchange rate was 61 per US $ and the rate as on 31st March, 2020 was 65 per US $. If Rutu Builders Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been @ 10.50%.
Compute Borrowing cost and exchange difference for the year ending 31st March, 2020 as per Accounting Standards 16. (Applicable LIBOR is 1%).

Solution

(i) Interest for the period 2019-20 = US $ 20 lakhs x 4% × Rs. 65 per US $ = Rs. 52 lakhs
(ii) Increase in the liability towards the principal amount = US $ 20 lakhs × Rs. (65 - 61) = Rs. 80 lakhs.
(iii) Interest that would have resulted if the loan was taken in Indian currency = US $ 20 lakhs × Rs. 61 x 10.5% = Rs. 128.1 lakhs
(iv) Difference between interest on local currency borrowing and foreign currency borrowing= Rs. 128.1 lakhs - Rs. 52 lakhs = Rs. 76.1 lakhs.

Therefore, out of Rs. 80 lakhs increase in the liability towards principal amount, only Rs. 76.1 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be Rs.128.1 lakhs being the aggregate of interest of Rs. 52 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 76.1 lakhs.
Hence, Rs. 128.1 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 "Borrowing Costs" and the remaining Rs. 3.9 lakhs (Rs.s 80 lakhs– Rs. 76.1 lakhs) would be considered as the exchange difference to be accounted for as per AS 11 "The Effects of Changes in Foreign Exchange Rates".

SUMMARY CHART

Borrowing Costs [AS-16]

- Meaning
  - Interest Costs
  - Amortisation of Ancillary costs
  - Finance charges
  - Exchange Difference : Interest on Local Borrowings − Interest on Foreign Borrowings
- Recognition
  - Qualifying Asset : Substantial period of time to get ready for use/sale : Capitalise
  - Others : w/off in period in which incurred : P&L A/c
- Borrowing Costs Eligible for Capitalisation
  - Specific Borrowings : Actual Borrowing Costs − Income from temporary Inv.
  - General Borrowings : Weighted Avg. Exp. x Capitalisation Rate
- Commencement of Capitalisation
  - Expenditure Incurred + Borrowing Costs Incurred + Activities in Progress
- Suspension of Capitalisation
  - When Active development interrupted
  - Exception: Substantial Technical / admin. work carried out, Temporary delay part of process, Unavoidable Reasons
- Cessation of Capitalisation
  - When substantially all the activities are complete.