VIEWPOINTS:

Applying IFRS® Standards in the Mining Industry

CAPITALIZATION OF BORROWING COSTS

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Background

Mining companies may borrow substantial amounts of external debt to fund either their exploration or development activities. Subsequent to the commencement of commercial production, a mining company may continue to incur borrowing costs and capital expenditures related to assets that take a substantial period of time to get ready for their intended use, such as the further development or extension of ore bodies.

Borrowing costs are interest and other costs that a company incurs in connection with borrowing funds. Borrowing costs may include interest expense calculated using the effective interest method, finance charges in respect of finance leases, and exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

IAS 23 *Borrowing Costs* provides specific guidance on the accounting for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset.

Issue

What factors should a mining company consider in determining whether borrowing costs should be capitalized?

Mining Industry Task Force on IFRS®

International Financial Reporting Standards (IFRS) create unique challenges for mineral resource companies. Financial reporting in the sector is atypical due to significant differences in characteristics between mineral resource companies and other types of companies. The Chartered Professional Accountants of Canada (CPA Canada) and the Prospectors & Developers Association of Canada (PDAC) created the Mining Industry Task Force on IFRS to share views on IFRS application issues of relevance to mineral resource companies. The task force views are provided in a series of papers that are available through free download. These views are of particular interest to Chief Financial Officers, Controllers and Auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by CPA Canada, PDAC or the organizations represented by the task force members.

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Viewpoints

Under IAS 23, a mining company capitalizes borrowing costs when it first meets all of the following conditions:

- it incurs expenditures which relate to a qualifying asset;
- it incurs borrowing costs; and
- it undertakes activities that are necessary to prepare the asset for its intended use or sale.

The activities necessary to prepare an asset for its intended use encompass more than the physical construction of the asset.

Activities may include technical and administrative work prior to the commencement of physical construction, such as those associated with obtaining permits.

In determining the accounting for borrowing costs, some factors to consider include, but are not limited to:

- Definition of a qualifying asset
- Assessment of probable future economic benefit
- Consistency between accounting policy decisions
- Costs not eligible for capitalization
- Suspension and cessation of capitalization.

Definition of a Qualifying Asset

Care should be taken to determine what constitutes a qualifying asset. A qualifying asset is one that necessarily takes "a substantial period of time to get ready for its intended use or sale." IAS 23 does not provide guidance on what constitutes a "substantial period of time." Company specific facts and circumstances must be considered in making this determination.

Qualifying assets may include inventories, processing plants, power facilities, intangible assets and mining projects that are in the exploration and evaluation, development or construction stages. Certain items will not meet the definition of a qualifying asset if they are already available for use in the condition purchased or if they do not take a substantial period of time to get ready for use. For example, the acquisition of equipment that is available to be used immediately in the mining process would not be considered eligible for interest capitalization. In some views, an exploration license would not meet the definition of a qualifying asset as it is available for use in the condition in which it is purchased and does not take a substantial period of time to get ready for use.

Financial assets are not considered qualifying assets. As a result of the adoption of IFRS 11 *Joint Arrangements*, some mining companies may have an increased number of equity accounted investments. An equity accounted investment is specifically not considered to be a qualifying asset under IAS 23, even if it is undergoing development activities. In contrast, when a company recognizes its share of the assets and liabilities of a joint operation under IFRS 11, capitalization of related borrowing costs is required to the extent that any of those assets are qualifying assets, provided the other requirements of IAS 23 are met.

Assessment of Probable Future Economic Benefit

IAS 23 requires capitalization of borrowing costs as part of the cost of qualifying assets. Such borrowing costs are capitalized as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably.

However, it is unclear how the requirements in IAS 23 regarding probable future economic benefits interact with the guidance in IFRS 6 *Exploration for and Evaluation of Mineral Resources*. For example, if a company incurs borrowing costs in the E&E phase that do not meet the probability criteria under IAS 23, differing views exist on how to account for such costs.

View 1: Account for borrowing costs under IFRS 6

In some views, E&E expenditures may include borrowing costs, if such borrowing costs are incurred by the company in connection with its E&E activities. Under IFRS 6, a company determines an accounting policy specifying which expenditures are recognized as exploration and evaluation assets and applies such policy consistently. In making this determination, the company would need to consider the degree to which the expenditure can be associated with finding specific mineral resources.[1]

View 2: Account for borrowing costs under IAS 23

In others' views, E&E expenditures do not include borrowing costs. Accordingly, these costs are accounted for under IAS 23. Under IAS 23, it must be considered whether the capitalization of borrowing costs would meet the criteria that probable future economic benefits be expected to flow to the mining company. From this perspective, if in the E&E phase a company incurs borrowing costs that do not meet the probability criteria under IAS 23, such costs are expensed as incurred.

Consistency Between Accounting Policy Decisions

E&E Expenditures

IFRS 6 requires a company to develop an accounting policy specifying which type of expenditures are recognized as exploration and evaluation (E&E) assets and to apply the policy consistently. Such an accounting policy considers the degree to which expenditures can be associated with finding specific mineral resources. As discussed above, in some views, E&E expenditures may include borrowing costs, if such borrowing costs are incurred by the company in connection with its E&E activities.

Judgment should be exercised to ensure that the accounting for borrowing costs is logical given the mining company's policy with respect to other E&E expenditures. For example, it may appear inconsistent if a mining company adopts an accounting policy which expenses incurred E&E expenditures yet capitalizes borrowing costs (incurred on those expenditures).

1 From this view, the requirements of IAS 23 do not override the exception in IFRS 6 that allows a company a choice of either expensing or capitalizing each type of E&E expenditure; this is because IFRS 6 defines E&E expenditure as expenditure incurred "in connection with" E&E activities, which in some views is broad enough to cover the related financing of such activities. Accordingly, from this perspective, a company may choose to either expense or capitalize borrowing costs related to E&E assets.

From this perspective, if a company has a policy to expense E&E expenditures as incurred, capitalizing borrowing costs on those E&E expenditures may not be appropriate. However, if a mining company recognizes E&E assets acquired through a business combination, while having an accounting policy of expensing all incurred E&E costs, capitalizing borrowing costs on the acquired E&E costs would not be inconsistent.

Non-E&E Expenditures

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, outside of the E&E phase, must be capitalized.

Costs Not Eligible for Capitalization

IAS 23 does not deal with the actual or imputed cost of equity including preferred capital not classified as a liability. Where a mining company has no borrowings and uses its own cash resources to finance the construction of property, plant and equipment, the mining company cannot assume that interest that could have been earned on that cash represents forgone benefit and could be capitalized.

Costs common to mining companies such as those in respect to the unwinding of a discount rate (i.e., accretion) related to environmental restoration and closure provisions cannot be capitalized as a borrowing cost under IAS 23.[2]

Additional Considerations under IFRS 15 *Revenue from Contracts with Customers*

If a mining company receives consideration from a customer in advance of transferring goods or services, then it recognizes a contract liability. The mining company applies the guidance in IFRS 15 to adjust the promised amount of consideration to reflect the time value of money for contracts with a significant financing component, which is subsequently recorded as interest expense. This interest expense meets the definition of a borrowing cost under IAS 23 because the interest represents the cost to the entity of borrowing funds from its customer. To the extent that the other criteria in IAS 23 are met, such interest should be capitalized.

Suspension and Cessation of Capitalization[3]

A mining company should suspend capitalization of borrowing costs during extended periods in which it suspends active development of a qualifying asset. IAS 23 does not provide guidance on what length of time is considered an "extended period," and therefore judgment is required in making this determination.

Cessation of borrowing cost capitalization occurs when substantially all the activities necessary to prepare the qualifying asset for its intended use are complete.

2 Refer to paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*.

3 Refer to paragraphs 22–25 of IAS 23 for additional guidance.

In the mining industry, however, it is common for the development of a mine site or a mining area to be completed in phases. This would mean that as each phase of mining activity is completed, the company removes the cumulative cost of such phase from its qualifying asset value and continues capitalizing borrowing costs for items remaining in the development phases which still meet the definition of a qualifying asset.

Capitalization of borrowing costs to each phase would be over that phase's development period. As such, it is possible to have a mine in commercial production but continue to have qualifying assets which are eligible for the capitalization of borrowing costs as these assets have not been advanced to the stage where they are ready for their intended use.

Impairment

IAS 36 *Impairment of Assets* will apply for many qualifying assets, however, certain assets are scoped out of IAS 36 (e.g. inventories).

Capitalization of borrowing costs is based on qualifying expenditures for qualifying assets.

Guidance in IAS 23.18 states that the average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditures to which the capitalization rate is applied in that period.

IFRS standards do not contain explicit guidance on the determination of qualifying expenditures subsequent to recognition of an impairment (i.e., whether or not qualifying expenditures should be reduced for impairment charges before applying the capitalization rate to determine the amount of borrowing costs eligible for capitalization).

In the experience of the Mining Industry Task Force on IFRS the appropriate amount of qualifying expenditures on which to capitalize interest is the *pre*-impairment amount. As noted in a recent IFRS Discussion Group Report (June 12, 2014), "the amount of qualifying expenditures is not affected by an impairment because the two are unrelated. The borrowing costs were still incurred for the expenditure. The guidance on average carrying value in paragraph 18 of IAS 23 is applicable in "normal" circumstances. Use of the average carrying value is not appropriate after an impairment".

For more information on this issue, please refer to the **IFRS Discussion Group report** dated June 12, 2014.[4]

Accounting for borrowing costs can be complex and requires the exercise of significant judgment in arriving at an appropriate conclusion. A mining company should consider consulting their accounting advisors and their auditors when undertaking such analysis.

4 IFRS Discussion Group Report—IAS 23: Impairment (June 12, 2014)

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For more information on IFRS visit www.cpacanada.ca/viewpointsmining.