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## **Endorsement of IAS 23 *Borrowing Costs***

### **Effect Study - Report**

## TABLE OF CONTENTS

1.	EXECUTIVE SUMMARY .....	4
2.	BACKGROUND.....	6
2.1.	Explanation of the issue .....	6
2.2.	How is the issue dealt with currently? .....	6
2.2.1.	Accounting standards .....	6
2.2.2.	Company practice.....	7
2.3.	How does the new standard suggest dealing with the issue?.....	8
2.4.	History of the project.....	8
3.	OVERVIEW OF STAKEHOLDER CONSULTATIONS .....	8
3.1.	Earlier consultations.....	8
3.1.1.	General outcome of the IASB consultation.....	8
3.1.2.	General outcome of the EFRAG consultation.....	9
3.2.	Overview and general outcome of the Commission Services' consultation....	10
3.2.1.	Organisation of the consultation and distribution of answers .....	10
3.2.2.	General outcome of the Commission Services' consultation .....	12
3.3.	Specific information on views by preparers.....	13
3.4.	Specific information on views by users .....	14
3.5.	Summary of reasons in favour or against the accounting treatment in the revised IAS 23 .....	14
4.	EFFECT ANALYSIS.....	15
4.1.	Methodology .....	15
4.2.	Discussion and analysis of main issues.....	16
4.2.1.	Components of the cost of an asset .....	16
4.2.2.	Comparability .....	17
4.2.3.	Significance of borrowing costs.....	18
4.2.4.	Financial analysis: separation between financing, operating and investing activities.....	19
4.2.5.	Costs for preparers and users .....	20
5.	OVERALL COST-BENEFIT CONSIDERATIONS.....	21
6.	COMMISSION SERVICES' CONCLUSION AND NEXT STEPS .....	22

ABBREVIATIONS.....	23
ANNEX 1: QUESTIONNAIRE.....	24
ANNEX 2: LIST OF COMMENTATORS.....	27

## 1. EXECUTIVE SUMMARY

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the European Union (EU). The Commission Services together with the European Financial Reporting Advisory Group (EFRAG) prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU.

This Effect Study relates to the endorsement of the revised International Accounting Standard 23 (revised IAS 23) *Borrowing Costs* issued by the International Accounting Standards Board (IASB) on 29 March 2007.

Companies as part of their normal activities construct or acquire different types of assets. In some cases, the construction process for assets could be lengthy and it could therefore take considerable time before the assets are ready for their intended use or for sale. During this time many companies take loans to finance the completion of the asset and incur borrowing costs.

Pursuant to Regulation 1606/2002/EC (IAS Regulation), the standard currently endorsed for use in the EU - International Accounting Standard 23 (IAS 23) *Borrowing Costs* (revised in 1993) - allows two principal alternatives to account for borrowing costs: either considering borrowing costs as an expense in the income statement, or capitalising them as part of the cost of the asset in the balance sheet. The current revision will eliminate one of the options in the existing standard and, therefore, will make the capitalisation method mandatory.

This effect study report analyses the potential effects of adopting the revised IAS 23 in the EU. It focuses on key issues raised during the IASB and EFRAG consultations as well as the recent one carried out by the Commission Services. It concludes that the adoption of IAS 23 would have positive cost-benefit effects. In particular, the report concludes that:

- The consultation carried out by the Commission Services showed that a majority of respondents prefer the capitalisation method and/or support the endorsement of the standard.
- The elimination of one of the current options will increase the comparability of the financial statements.
- Technical discussions in the IASB and EFRAG as well as research done by the Commission Services indicate that in a historical cost basis the capitalisation of borrowing costs and their inclusion in the cost of the assets is a better conceptual approach than the expensing of borrowing costs.
- Despite the fact that the majority of the European companies are currently applying the expensing method, the implementation of the revised IAS 23 is not expected to have a significant impact on several of them as they may not have any qualifying assets or borrowing costs. The capitalisation of borrowing costs is of relevance only for those companies that are asset capital-intensive. Our consultation and other reports reveal that these companies generally prefer to apply the capitalisation method.

- The revision of IAS 23 will result in some initial implementation costs and will add some complexity as the expensing method is simpler to apply than the capitalisation method. The main part of these costs will be related to the first implementation of the revised standard and therefore not recurring. The report concludes that the benefits from using the standard are more important than the implementation costs.
- Discussions in the EFRAG User Panel showed that the elimination of an option will enhance comparability which was considered as a significant benefit. The discussions also showed that the importance of borrowing costs can vary from industry to industry and that these are obviously more relevant for capital intensive industries. Some analysts pointed out that borrowing costs are normally not key for their analysis. From a cost perspective, users may have additional costs to adjust the figures for analysis purposes but will also benefit from some savings resulting from the elimination of one option.
- The IASB has the intention to produce an ex-post effect study after two years of application of the standard. Such a review should particularly look into the areas highlighted by commentators during the consultations.

It is recommended that the revised IAS 23 should be endorsed in the European Union as the benefits of its endorsement will outweigh the costs.

## 2. BACKGROUND

The European Commission has agreed with the European Parliament that Effect Studies should be prepared for new accounting standards and interpretations up for endorsement in the EU. The Commission Services together with EFRAG prepare these studies containing description of the accounting issues involved, results from stakeholder consultations as well as analysis of effects of using the new accounting rules in the EU. Effects Studies are publicly available in the European Commission website<sup>1</sup>.

### 2.1. Explanation of the issue

Companies as part of their normal activities construct, produce or acquire different types of assets, for example, buildings, plants or machinery. In some cases, the construction or production process for assets could be lengthy and it could therefore take considerable time before the assets are ready for their intended use or for sale. This can also occur when an entity acquires an asset that cannot be used right away, as it may need to be subject to further operations before it is ready for its intended use or sale.

During the construction or production phase, many companies take loans to finance the completion of the asset. This implies that companies incur borrowing costs, and the issue occurs how these should be accounted for during the period until the asset is ready for its intended use or sale.

### 2.2. How is the issue dealt with currently?

#### 2.2.1. Accounting standards

There are two principal alternatives to account for borrowing costs: either considering borrowing costs as an expense in the income statement, or capitalising them as part of the cost of the asset in the balance sheet.

IAS 23 *Borrowing Costs* was issued in 1993 and is the standard currently endorsed for use in the EU. Borrowing costs are defined as "interest and other costs incurred by an entity in connection with the borrowing of funds"<sup>2</sup>. The standard generally requires immediate expensing of borrowing costs in the period in which they are incurred. The standard also allows an alternative treatment; under this alternative borrowing costs that are directly attributable to the acquisition, construction or production of a *qualifying asset* shall be capitalised. IAS 23 indicates that a *qualifying asset* is "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale"<sup>3</sup>. Therefore, if this alternative treatment is applied borrowing costs are capitalised as part of the cost of the qualifying assets.

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<sup>1</sup> [http://ec.europa.eu/internal\\_market/accounting/index\\_en.htm](http://ec.europa.eu/internal_market/accounting/index_en.htm)

<sup>2</sup> Paragraph 4 of IAS 23

<sup>3</sup> Paragraph 4 of IAS 23

In the US, interest costs<sup>4</sup> are regulated by Statement of Financial Accounting Standards 34 (SFAS 34) *Capitalization of interest cost* (approved in 1979). This Standard requires capitalisation, i.e. the alternative treatment of IAS 23. According to SFAS 34 the cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use, including interest cost incurred during that period. If an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset<sup>5</sup>.

### 2.2.2. *Company practice*

Different surveys and studies have been made about the application by companies of the capitalisation method or of the expensing method.

The Institute of Chartered Accountants in England and Wales (ICAEW) Study<sup>6</sup> of the 2005 accounts of 200 European companies shows that 24.5% of companies capitalise borrowing costs and 74.5% expense borrowing costs.

Another report made by Ernst and Young<sup>7</sup> covering 65 companies throughout the world applying IFRS shows that in the sample significantly more companies expensed than capitalised borrowing costs and that "as might be expected, the companies that capitalised borrowing costs tended to be engaged in capital-intensive activities (eg. oil and gas, mining, chemicals) although practice varied in some industries (e.g. utilities, telecommunications, pharmaceuticals, retail)"<sup>8</sup>.

A third report by KPMG<sup>9</sup> which examined the alternative selected for borrowing costs over 149 companies throughout the world shows that 59% of these companies capitalise their borrowing costs and 41% expense them. 53 % of the EU companies in the sample use the capitalisation approach. If we distribute this sample by countries we can observe that Spain, France, the Netherlands and Italy, are countries where the capitalisation method is more applied, whereas the expensing method dominates in Germany, Sweden and the United Kingdom (UK).

Among the respondents to the Commission stakeholder consultation slightly more companies used the capitalisation method.

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<sup>4</sup> SFAS 34 uses the term "interest costs" whereas IAS 23 uses the term "borrowing costs". Both terms are not equivalent as borrowing costs is a broader definition

<sup>5</sup> Paragraph 6 of SFAS 34

<sup>6</sup> See *EU implementation of IFRS and the fair value directive*, a report for the European Commission, ICAEW

<sup>7</sup> See *Observations on the implementation of IFRS*, Ernst & Young, September 2006

<sup>8</sup> Page 10 of the report *Observations on the implementation of IFRS*, Ernst & Young, September 2006

<sup>9</sup> See *The application of IFRS: Choices in practice*, KPMG, IFRS December 2006

### **2.3. How does the new standard suggest dealing with the issue?**

Under the revised IAS 23 *Borrowings Costs*, all borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalised and form part of the cost of the asset. Other borrowing costs should be recognised as expenses in the income statement.

Therefore, the revised version of the standard eliminates one of the options in the existing standard (the immediate expensing approach). The previous alternative treatment (the capitalisation approach) is required.

Other minor changes - mostly of a drafting nature - have been introduced in the revision of IAS 23. There is however also an amendment to the scope of the standard; the revised IAS 23 does not require the capitalisation of borrowing costs relating to assets measured at fair value, and of inventories that are manufactured or produced in large quantities on a repetitive basis, even if they take a substantial period of time to get ready for use or sale.

The revised standard applies to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009. Earlier application is permitted.

### **2.4. History of the project**

The project to revise IAS 23 is part of the convergence program between the IASB and FASB, more specifically the short term convergence project<sup>10</sup>. The objective of the short-term convergence project is to reduce differences between IFRS and the United States Generally Accepted Accounting Principles (US GAAP) that can be resolved in a relatively short time and can be addressed outside major projects.

The IASB added this project to the agenda in April 2004 and commenced to work in the amendment of IAS 23 in October 2005. The IASB did not deem a Discussion Paper necessary for this project as the objective was to reduce major current differences between IAS 23 and SFAS 34 and not to develop a new approach for borrowing costs. In May 2006 the IASB published an Exposure Draft for public comment. The revised IAS 23 *Borrowing Costs* was published in March 2007.

## **3. OVERVIEW OF STAKEHOLDER CONSULTATIONS**

### **3.1. Earlier consultations**

#### *3.1.1. General outcome of the IASB consultation*

The IASB carried out a consultation according to its due process and received 86 comment letters<sup>11</sup>, about half of the answers stemming from European Union stakeholders.

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<sup>10</sup> See *A Roadmap for Convergence between IFRSs and US GAAP – 2006-2008*. Memorandum of Understanding between the FASB and the IASB, 27 February 2006

<sup>11</sup> Observer notes, Comment letter analysis (Agenda Paper 6), 17 November 2006, paragraph 1



The distribution by type of stakeholder shows that most of the comment letters to the exposure draft were sent by accountants and auditors (36%) followed by preparers (34%) and public authorities (19%) and finally by users (7%)<sup>12</sup>.

Many respondents to the IASB consultation expressed the opinion that the Exposure Draft did not explain properly the reasons for the changes introduced. In their views, the IASB should have made a comprehensive review of the strengths and weaknesses of the expensing method and the capitalisation method. Also there were some respondents that thought that both IAS 23 and SFAS 34 should have been overhauled and updated to incorporate more current accounting thinking.

Some commentators therefore believe that the standard should not be included as part of the short-term convergence project.

In response to the above mentioned criticism, the IASB incorporated in the Basis for Conclusions of the Standard more explanations about the reasons for the elimination of the expensing method. The IASB argued that from a technical perspective borrowing costs are part of the cost of the asset and the capitalisation of borrowing cost will be an improvement in financial reporting<sup>13</sup>.

Analysis of the comment letters showed that many respondents disagreed with the proposals of the Exposure Draft. Many commentators indeed mentioned that the move from the expensing method to the capitalisation method will imply additional costs for preparers especially during the implementation phase. Other respondents mentioned that the guidance regarding the way of determining the costs to be capitalized is not sufficiently detailed which may lead to complex judgements and to lack of consistency in application. Other commentators were of the view that borrowing costs should not be considered as part of an asset as the funding structure of the companies will influence the cost to be recognised. We will discuss in more details these views in the 4.2 section of this report.

In the Basis for Conclusions, the IASB states that it - despite the comments - decided to publish the Standard as "the additional benefits in terms of higher comparability, improvements in financial reporting and achieving convergence in principle with US GAAP exceed the additional costs of implementation"<sup>14</sup>.

On 29 March 2007, the IASB adopted the amendment to IAS 23. It was approved with 3 dissenting views (i.e. 3 out of 14 Board members).

### *3.1.2. General outcome of the EFRAG consultation*

The European Financial Reporting Advisory Group (EFRAG) as part of its due process carried out two consultations.

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<sup>12</sup> These percentages are estimations made by the Commission Services. There were also around 4% of the answers sent by individuals.

<sup>13</sup> Paragraphs 9 and 13 of the Basis for Conclusions of revised IAS 23

<sup>14</sup> Paragraph 13 of the Basis for Conclusions of revised IAS 23

The first consultation was part of the preparation of an answer to the IASB to the Exposure Draft preceding the revised IAS 23. EFRAG received 18 comment letters whereof 33% expressed support for the suggested changes.

The second consultation related to the issuance of EFRAG's endorsement advice. EFRAG carried out an evaluation of revised IAS 23 according to the endorsement criteria in the IAS Regulation, and concluded that the revised standard satisfies the criteria. A minority of EFRAG members expressed dissenting views; from their point of view the revised IAS 23 should not be endorsed. EFRAG concluded that the amendment to IAS 23 is consistent with the IASB Conceptual Framework and that the revision will enhance comparability. EFRAG also considered whether the right option had been eliminated, and different views were expressed by members of the Technical Expert Group (TEG). Nevertheless, EFRAG concluded that the revised IAS 23 passes the overall cost-benefit test, although it may have cost implications for certain individual companies.

During the second consultation 8 comment letters were received, mostly from national accounting standard-setters. Most commentators supported endorsement. The main reasons for the support were the improvement of comparability resulting from the elimination of an optional treatment, the implications of non-endorsement as it will create a difference between "full" IFRS and IFRS endorsed in the EU and that the endorsement will be a step towards convergence. We will discuss in more details these views in the 4.2 section of this report.

The Standards Advice Review Group (SARG) examined the EFRAG endorsement advice on 18 July 2007 and concluded that this advice was well balanced and objective.

## **3.2. Overview and general outcome of the Commission Services' consultation**

### *3.2.1. Organisation of the consultation and distribution of answers*

On 7 December 2007, the Commission Services published a questionnaire on the revised IAS 23 for public consultation. This questionnaire<sup>15</sup> included general questions as well as specific questions to preparers and to users. The deadline for comments was January 25, 2008.

The Commission Services received 34 answers<sup>16</sup> to the questionnaire. Some of the answers received represent the view of one single respondent, whereas others were given by associations representing several other stakeholders. Some respondents did not answer the specific questions to the questionnaire, but preferred sending a letter summarizing their comments.

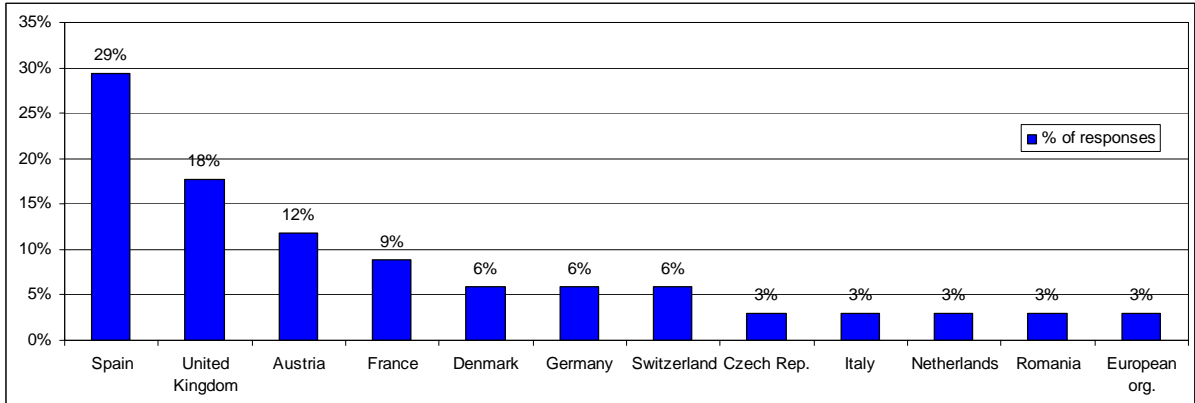
The Commission Services received answers from 11 Countries (10 Member States and Switzerland). The distribution of answers per countries is presented in the figure below.

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<sup>15</sup> See Annex 1

<sup>16</sup> See Annex 2

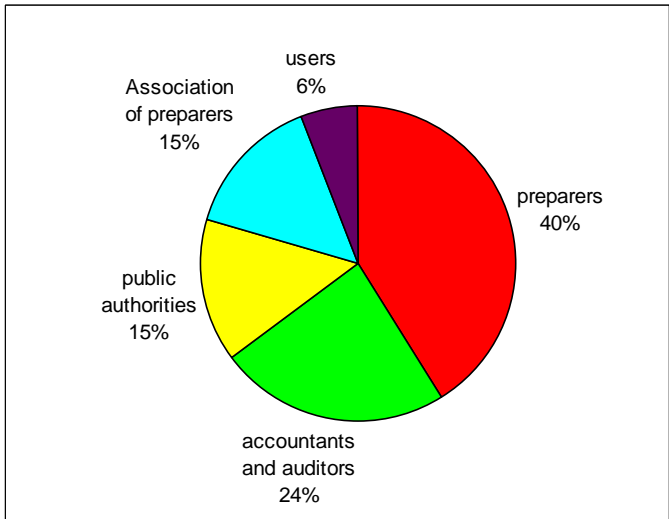
Fig. 1. Responses per country



Source: Commission own analysis

In terms of distribution by type of stakeholders, most answers came from preparers or their associations (55%), followed by accountants and auditors (24%), public authorities (15%) and users<sup>17</sup> (6%). The following figure shows the distribution of answers by type of stakeholder.

Fig. 2. Responses by type of stakeholder



Source: Commission own analysis

Most of the answers from preparers were from listed companies or associations representing listed companies (89%), the vast majority of them were listed on EU stock exchanges.

More than one third of the respondents (38%) participated also in the consultations organised by IASB and/or EFRAG.

<sup>17</sup> One of the respondents representing users was an association comprising around 60 investment banks (LIBA – London Investment Banking Association). In addition to this, the Commission Services have taken into account the views of users who responded to the IASB Consultation. Furthermore, the Services have consulted the EFRAG User Panel (see 3.4 below).

### 3.2.2. General outcome of the Commission Services' consultation

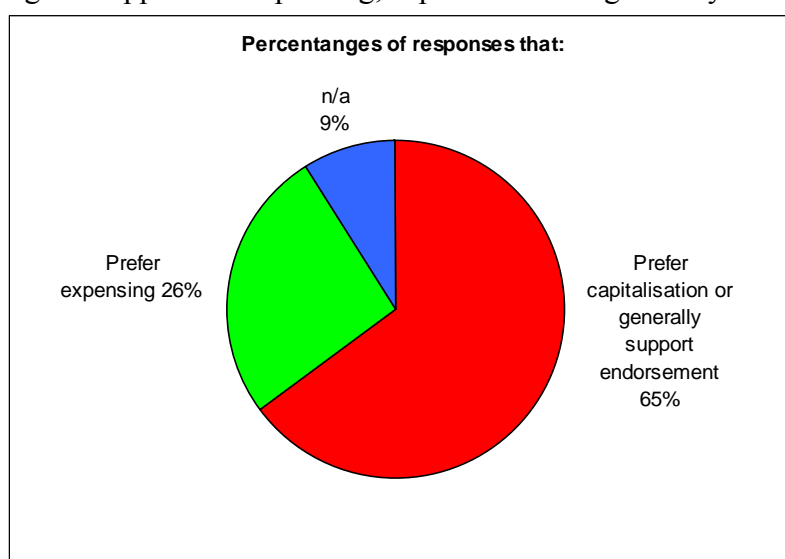
#### General preference for the capitalisation or the expensing method

The majority of the respondents who expressed a preference for one of the methods supported the capitalisation approach required by the revised IAS 23. In addition, other respondents expressed general support for the endorsement of the standard.

65% of the respondents supported the revised IAS 23. Among these respondents, 42% of the respondents stated their preference for the capitalisation method and 23% expressed their general support for endorsement.

The following figure summarizes the answers received to the consultation.

Fig. 3. Support for expensing, capitalisation or generally for endorsement



Source: Commission own analysis

#### Qualitative characteristics<sup>18</sup> of the information

The majority of respondents stated the opinion that the capitalisation method provides more relevant, comparable, reliable and understandable information, or that they generally support the endorsement of the revised IAS 23. Concerning **relevance, comparability and understandability**, the answers received are very similar to the results presented above in figure 3, i.e. 46% of the respondents believed that the capitalisation method provides more relevant, comparable and understandable information than the expensing method. 28% of the respondents disagreed. 23% of the respondents generally supported the endorsement of the standard.

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<sup>18</sup> Relevance, reliability, comparability and understandability as referred to in article 3 of Regulation 1606/2002.

Concerning *reliability*, 38% of the respondents were of the opinion that the capitalisation method provides more reliable information than the expensing method, and 35% were of an opposite opinion. In this case, 23% of the respondents expressed general support for endorsement. This difference between these qualitative characteristics may be explained by the view of some respondents that although in general they prefer the capitalisation method they expressed that this approach is also more complex and more difficult to apply.

#### *Main costs and benefits of the revision of IAS 23*

On the benefit side, respondents referred mainly to three issues: firstly, the revision will improve the comparability between companies; secondly, from a conceptual point of view borrowing costs should be part of the cost of the asset; and, lastly, the revision is a step towards convergence with US GAAP and avoids differences between EU IFRS and "full" IFRS.

On the cost side, respondents mainly mentioned two issues: the complexity and application problems of the capitalisation method compared to the expensing method; and the implementation costs to be incurred by companies as a result of the change in accounting rules.

### **3.3. Specific information on views by preparers**

55% of the respondents to the Commission consultation were preparers or associations of preparers. This includes, for instance, large industry associations of listed companies like ACTEO, AFEP and MEDEF<sup>19</sup> in France, or the Quoted Companies Alliance in the UK, large industry associations of companies working in highly capital intensive industries such as ASETA in Spain (a Spanish association of public works companies) or large companies in the electricity, manufacturing, and pharma industry.

Of these respondents, there were slightly more answers expressing that borrowing costs are significant and that they currently apply the capitalisation method. It appears that the capitalisation method is used and also is of relative significance for the majority of companies that are asset capital intensive. It also appears that the companies that currently apply the capitalisation method prefer the capitalisation method whereas the companies currently applying the expensing method prefer the expensing method.

Generally, the companies mentioned that the following changes were necessary in the past or will be necessary in the future to apply the capitalisation method: modifications in the information systems (IT) systems and calculation of borrowing costs to be capitalised (allocation of borrowing costs across the group, definition of the qualifying assets or fix a materiality level before which borrowing costs will not be capitalised). This implies additional costs that are principally implementation costs rather than recurring costs. As regards the estimation of cost derived from the implementation of the standard, there was not much numerical estimation.

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<sup>19</sup> ACTEO (Association pour la participation des entreprises françaises à l'harmonisation comptable internationale), AFEP (Association Française des Entreprises Privées) and MEDEF (Mouvement des Entreprises de France)

The main arguments in favour of capitalisation of the borrowing costs are the fact that this method shows the economic reality of the asset costs, the removal of one option will improve comparability and this change will be step towards convergence. The main arguments against capitalisation are the cost of implementation, its complexity and the fact that the capitalisation of borrowing costs may reflect more the structure of financing of a company than the cost of the assets.

### **3.4. Specific information on views by users**

The Commission Services received two users individual replies to its consultation. One of them was from the London Investment Banking Association, which represent around 60 investment banks: the outcome of this reply was that "neither the proposed amendments to IAS 23 nor the proposed interpretations appeared likely to have any material effects on our members, either as preparers or as users of accounts". A bank respondent expressed a negative view on the revision of IAS 23. Despite the fact that this user is generally supporting the elimination of options, the capitalisation method is criticized, as it will make the asset value depending from the structure of financing of companies, and as it will create less clarity in the split between operating and financing activities as the interest expenses will go in the income statement via depreciation.

The IASB received also few answers from users to its consultation. In general these users were in favour of the removal of accounting alternatives and of the convergence process. However, they expressed a preference for the expensing method as they needed to split between financing and operating costs. Also, the comparability would not be enhanced because the capital structure of an entity could affect the cost of an asset. Others also pointed out that under a historical cost basis the capitalisation of borrowing costs is conceptually more correct and that will show better the economic reality of the company.

In order to complete the analysis of user views, the Commission Services consulted the EFRAG User Panel. The panel consist of a large range of users. These discussions revealed that the elimination of an option in the standard was seen as a significant benefit as comparability is hugely valuable to users. Some users also mentioned that borrowing costs were generally not very important for their analysis but could be relevant in some type of industries (asset capital intensive industries). The significance of disclosures was mentioned and the fact that users need to know the amounts capitalised in order to consider these amounts in their analysis. The convergence process and the decision not to diverge from IFRS were of great importance for users.

### **3.5. Summary of reasons in favour or against the accounting treatment in the revised IAS 23**

Constituents to the consultations mentioned above gave the following main reasons **in favour of the revised IAS 23**:

- Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of the asset.
- The removal of one option will result in higher comparability between entities.
- Higher comparability between assets developed internally and assets acquired from third parties will be achieved (see discussion in 4.2.2).

- The revision will achieve one goal of the Memorandum of Understanding signed between the IASB and the FASB regarding convergence between IFRS and US GAAP and will contribute to the convergence process with US GAAP.

Constituents presented the following main reasons **against the revised IAS 23**:

- There is not sufficient explanation and theoretical basis in the revised standard for the removal of the expensing method.
- The capitalization method will involve additional costs for those companies currently using the expensing method as the capitalisation method is more complex to apply, and as there is lack of application guidance in the standard.
- Comparability will decrease between assets due to differences in company's funding structures (see discussion in 4.2.2).
- The financial analysis of a company requires separation between financing, operating and investing activities.

#### **4. EFFECT ANALYSIS**

##### **4.1. Methodology**

The report aims at analysing the potential effects of introducing the revised IAS 23 in the EU. The analysis of these potential effects was prepared by the Commission services using the following sources of input in preparing the report:

- Answers to the questionnaire<sup>20</sup> issued by the Commission services for public consultation on 7 December 2007.
- Results and comment letters from the earlier consultations by the IASB and EFRAG on the Exposure Draft and on the Endorsement Advice.
- Academic research and reports by organisations or associations.
- Interviews and meetings with EFRAG staff and EFRAG User Panel.

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<sup>20</sup> See Annex 1 and 2

## 4.2. Discussion and analysis of main issues

### 4.2.1. Components of the cost of an asset

**Issue:** Is it conceptually correct to include borrowing costs as part of the cost of an asset?

Many commentators of the Commission consultation supported the view that borrowing costs attributable to the acquisition, construction or production of a qualifying asset should be part of the cost of the asset. Some commentators particularly stated that capitalisation of the borrowing costs will show the economic reality of the activities of the company. Few commentators challenged the conceptual reasons behind the capitalisation of borrowing costs, even if they for practical reasons would have preferred to keep the expensing approach. These commentators mentioned the need to distinguish cost of operations from financing costs (see 4.2.4).

The IASB, the FASB and EFRAG all concluded that capitalisation of borrowing costs is the more correct accounting treatment under an historical cost basis and ensures that the total cost of the asset is reflected in the balance sheet<sup>21</sup>. The IASB concluded that recognising immediately as an expense borrowing costs relating to qualifying assets does not give a faithful representation of the cost of the asset<sup>22</sup>. The IASB staff commented that "the underlying conceptual argument in this project is straightforward. If borrowing costs incurred to fund the construction of an asset are part of its cost, there is no basis for excluding those costs. One would not exclude the allocated cost of labour or overhead on a self-constructed asset, simply because capitalisation requires allocation. If borrowing costs are not part of the asset's cost, there is no basis for capitalising them".<sup>23</sup>

However, during the consultations, some commentators expressed the need to consider another approach than those currently included in IAS 23. Certain commentators argued that a faithful representation of cost would be achieved by capitalising an economic interest cost (applying a current market risk-adjusted rate of return for a rate that would reflect market assessments of the time value of money and the risk specific to the asset). This view was taken into consideration by the IASB that concluded that the current amendment of IAS 23 is a short-term convergence project whereas the development of this alternative approach would need a full reconsideration<sup>24</sup>.

The Commission Services conclude that there is widespread conceptual support for including borrowing costs in the cost of an asset. The revised IAS 23 will improve financial reporting as capitalising borrowing costs will better reflect the economic reality of companies.

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<sup>21</sup> Paragraph 6 of SFAS 34, paragraph 9 of Basis for Conclusions of revised IAS 23 and Paragraph 3 and 4 of EFRAG Endorsement advice

<sup>22</sup> Paragraph 9 of Basis for Conclusions of revised IAS 23

<sup>23</sup> Observer notes, Comment letter analysis (Agenda Paper 7), 12 December 2006, paragraph 4.

<sup>24</sup> Observer notes, Comment letter analysis (Agenda Paper 7), 12 December 2006, paragraphs 35-37



#### 4.2.2. Comparability

**Issue:** Does the elimination of the expensing option improve the comparability of the financial statements?

During its deliberations, the IASB stated that the application of only one method will enhance comparability<sup>25</sup>. The Commission Services consultation clearly confirmed this view.

The elimination of the expensing method will improve the comparability of the financial statements as all companies will have to capitalise their borrowing costs. There will furthermore also be improvements in consistency in IFRS application<sup>26</sup>. Ernst & Young concludes in their IFRS implementation report that alternative treatments are a further source of inconsistency among companies which negatively affects comparability<sup>27</sup>. The EFRAG User Panel expressed that the elimination of an option results in a significant benefit for the users of the financial information.

However, some commentators believed that options in accounting standards provide flexibility for entities, enabling them to use the most appropriate accounting treatments in their particular circumstances.

Even if the reduction to one approach will improve comparability, some commentators believe that comparability problems could still arise even if all companies use the capitalisation approach. Firstly, there is a sentiment that the standard does not contain sufficient guidance in applying the capitalisation method<sup>28</sup>. This will require the exercise of judgement to determine costs capitalised and could lead to inconsistency and may jeopardise comparability. Secondly, some commentators are of the opinion that the capitalisation of borrowing costs will result in different cost being attributed to assets that are otherwise identical, depending on whether the asset's acquisition, construction or production was financed by debt, equity or a combination of both. In this case the cost of the assets will be different depending of the financing structure of the companies. These commentators believe that if the expensing method were applied, the comparability would be increased between assets that are equity financed and those that are debt financed, as no financing cost will be included in the cost of the asset.

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<sup>25</sup> Paragraph 2 of Basis for Conclusions of revised IAS 23

<sup>26</sup> Letter a). i) of paragraph 9 and paragraph 4 of EFRAG Endorsement Advice

<sup>27</sup> See page 9 of the report *Observations on the implementation of IFRS*, Ernst & Young, September 2006

<sup>28</sup> Areas where some commentators would have liked more guidance are for example: definition of the qualifying assets, determination of the capitalisation period to capitalise borrowing costs or determination of an interest rate at group level.

Commentators also raised the following complex issues related to the application of the standard: the treatment of intra-group loans; the allocation of borrowing costs to the various components of a single qualifying asset; the interaction between IAS 23 and IAS 39 with respect to derivatives relating to borrowings; the application of adjustments to interest for foreign exchange differences or items to be included in investment income.

Other commentators to the consultations, however, believed that capitalisation will lead to greater consistency and improve comparability between assets constructed internally and assets acquired from third parties. Similarly, other stakeholders expressed the view that capitalisation will result in asset costs that more closely match the market prices of completed assets. Treating borrowing costs as an expense distorts the choice between purchasing and constructing a tangible financial asset because the price paid to a third party includes these costs.

Lastly, the IASB Staff notes that "whilst capitalising borrowing costs does not achieve comparability among liability financed and equity financed assets, it achieves comparability among all non equity-financed assets, which is better than the current position. Indeed, some Staff argue that so few assets now are equity financed that capitalisation of borrowing costs achieves almost total comparability"<sup>29</sup>.

The Commission Services note that the majority of the respondents to the consultations see clear benefits in the elimination of an option as it will improve comparability and consistency. The revised IAS 23 will contribute to improve comparability between the assets developed internally and those acquired from a third party.

The Commission Services note the complexity of the standard may lead in inconsistent application, nevertheless the necessity to exercise judgement is normal in a principle based accounting system such as IFRS.

#### 4.2.3. *Significance of borrowing costs*

**Issue:** How important are borrowing costs for companies preparing financial statements? Are borrowing costs significant for users and other stakeholders?

From our different sources of information, it seems that the significance of borrowing costs varies from industry to industry. Borrowing costs may be of relevance in those sectors that are engaged in capital-intensive activities, for example oil and gas, construction, manufacturing, pharmaceuticals or utilities<sup>30</sup>. In the Commission consultation, it appears that the companies highlighting the significance of borrowing costs were often capital-intensive and in most cases preferred the capitalisation method to the expensing method.

For most other companies, borrowing costs seem to be of only minor importance. This was also confirmed by comments from users and from the discussions with the EFRAG User Panel. The Panel however highlighted that borrowing costs could be important for the analysis of certain activities, such as regulated industries or utility companies.

The Commission Services note that the accounting for borrowing costs is important for

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<sup>29</sup> See Observer notes, Comment letter analysis (Agenda Paper 7), 12 December 2006, , paragraph 14 and paragraph 10 of Basis for Conclusions of revised IAS 23

<sup>30</sup> See also *Observations on the implementation of IFRS*, Ernst & Young, September 2006 and *The application of IFRS: Choices in practice*, KPMG, IFRS December 2006

certain industries. Companies in these sectors generally support capitalisation. For most other companies borrowing costs are normally not very significant.

#### 4.2.4. *Financial analysis: separation between financing, operating and investing activities*

**Issue:** Is the revised IAS 23 appropriate for financial analysis purposes? What would be the consequences on the split between financing, operating and investing activities?

The Commission services compiled the information for users mainly through its consultation as well as the IASB and EFRAG consultations and the information received from the EFRAG User Panel. There seems to be some divergence between users as to which method is preferable.

Some analysts and rating agencies prefer that the presentation of an entity's business/operating results be separated from the capital structure of the entity. Capitalising borrowing costs does not allow that distinction, and does not help in identifying the level and trend of a company's financing costs. In addition, capitalizing will transfer finance costs in operating costs via depreciation.

Capitalising borrowing costs also means that some users have to make adjustments to the published figures to arrive at cash flow amounts which are needed in order to forecast future cash flows. Similarly, their analysis of an entity's cost of capital becomes more difficult to discern than if borrowing costs had been expensed.

Nevertheless, the users that are against the capitalizing method are most of time clear supporters of the convergence between IASB and FASB and also of the elimination of options that in general simplifies their analysis.

On the other hand, there are other users that are supportive for the capitalizing method. They argued that the capitalisation approach is preferable; they see it as more consistent with the application of the historical cost basis than immediate expensing. In their view, fundamental to informative financial reporting is the adoption of the accruals basis of accounting, which requires that expenses are reported when they are incurred and not when they are paid. The proper application of the accruals basis requires assets to be measured at their full cost. In this case, disclosure of the amounts being capitalised is relevant to users.

At last, there are other users especially among analysts that consider that borrowing costs are not significant inputs for their analysis and therefore does not express a clear preference whereas they support the endorsement of the standard to avoid differences with "full" IFRS and to support the global convergence process.

The Commission service note that there are mixed views among the users about the pertinence of the revision regarding financial analysis purposes. However, it appears that the users that preferred the expensing method are at the same time very supportive of the elimination of options and of the convergence process between IFRS and US GAAP and would see as a substantial disadvantage a divergence between the EU IFRS and "full" IFRS

that would result from a non endorsement of the standard.

#### 4.2.5. *Costs for preparers and users*

**Issue:** Will the revised IAS 23 create additional costs for preparers and users?

##### *Costs for preparers*

Applying the new standard will create costs for those companies that until now used the expensing method. Costs stem from two main sources:

- *need to adapt administrative systems and procedures*, including changes to information systems (IT), training and communication expenses, costs for obtaining relevant data to perform the calculations as well as increased audit costs.
- *internal and external technical resources* needed to establishing how the standard should be applied as very little general application guidance is included in IAS 23.

The borrowing cost issue is specific and not all companies are affected. However, a significant part of the companies concerned would have to change their current accounting for borrowing costs (estimations range from 50% to 75%, see above 2.2.2). Nevertheless, it has to be noted that several companies that will have to change their accounting policy may not have any qualifying assets or borrowing costs and therefore the revised IAS 23 will not have any impact for them. There are always certain unavoidable costs related to the implementation of a new accounting standard, but after discussions with preparers, the IASB had been convinced that there would be no difficulty for companies to apply the IAS 23 requirements<sup>31</sup>.

Some commentators to the Commission consultation argued that the implementation costs would be important, particularly because of IT changes and the difficulty to apply the standard due to the lack of guidance. Some respondents, however, indicated that they had used the capitalisation method for a long time without facing major difficulties. Furthermore, these companies stated that the cost of applying this method was not really relevant.

It is important to notice that there is no requirement to use the standard retrospectively. Furthermore, most of costs are linked to the first implementation, and will not be recurring.

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<sup>31</sup> Paragraph 14 Basis for Conclusions of IAS 23 and Observer notes, Comment letter analysis (Agenda Paper 7), 12 December 2006, paragraph 16

### *Costs for users*

Generally speaking, the elimination of an option in the standard will reduce costs for users as they will be able to work with data prepared in the same way by all entities. However, some users will face additional costs in order to adjust the figures in order to split the operating expense and the financing expense. In EFRAG User Panel it was mentioned that borrowing costs is not a key issue for their analysis in most of the cases.

The Commission Services conclude that the implementation of the revised IAS 23 will create certain costs for the preparers of financial statements. Nevertheless, these costs will concern mainly companies operating in highly capital intensive industries that are not currently applying the capitalisation method. Problems in first-time application are likely to be quickly remedied. Most costs are furthermore not recurring.

Users may face some additional costs to adjust the figures. Nevertheless, the elimination of one option will allow them to work with data prepared in the same way by all entities.

## **5. OVERALL COST-BENEFIT CONSIDERATIONS**

The Commission Services have considered the main costs and benefits of endorsing the revised IAS 23. The Services tentatively conclude that the benefits of the revision outweigh the costs introduced by the revision. The main benefits of the revision will be the following:

- The elimination of one option will increase the comparability of the financial statements as all companies will have to account their borrowing costs in the same manner.
- From a conceptual point of view, it seems that in an historical costs basis the consideration of borrowing costs as part of the cost of an asset is more correct than the expensing method because it ensures that the total costs of the asset is reflected in the balance sheet.
- This revision will be a step in the convergence process between the IASB and the FASB and will avoid a divergence between "full" IFRS and EU IFRS. This clearly contributes to the goal shared by the European Union to achieve a single global accounting language (IFRS) accepted and applied worldwide.
- The capitalisation of borrowing costs is of relevance for those companies that are asset capital-intensive. Our consultation and other reports reveal that these companies generally prefer to apply the capitalisation method.

The main costs of the revision will be the following:

- Users may face some additional costs to adjust the figures. Nevertheless, the elimination of one option will allow them to work with data prepared in the same way for all entities.
- Companies that are currently expensing their borrowing costs will have to change their accounting policy and this will add some complexity and some application judgements as the expensing method is simpler than the capitalisation method.

- Companies that are currently expensing their borrowing costs will incur some costs derived from the change in the method and its application.

As a global picture, it could also be mentioned that the revision of IAS 23 does not have significant impacts for many stakeholders. The majority of the stakeholders that expect significant impacts are more or less located in very capital intensive industries like construction, public works, long term contracting etc. and they prefer in their majority the capitalizing method for its benefit from a conceptual and comparability point of view: as a consequence they support the endorsement. Several stakeholders that do not expect significant impact are also in favour of the endorsement to avoid the costs that would arise from an additional divergence between "full" IFRS and EU IFRS and to support the progress in the convergence process between IFRS and US GAAP.

## **6. COMMISSION SERVICES' CONCLUSION AND NEXT STEPS**

The Commission Services believe that the revised IAS 23 will have positive cost-benefits effects and that it should therefore be endorsed in the EU without delay.

Considering the comments received in the consultations, the Commission Services consider that it is important to closely follow how the standard will work in practice. In this regard, the Services welcome that the IASB will review the functioning of the standard after two years of application.

*The Commission Services would like to express their appreciation to all stakeholders that provided valuable input to the report.*

## **ABBREVIATIONS**

<b>EC</b>	European Commission
<b>EFRAG</b>	European Financial Reporting Advisory Group
<b>EU</b>	European Union
<b>EU IFRS</b>	International Financial Reporting Standards adopted by the EU
<b>FAS/SFAS</b>	Financial Accounting Standard/Statement of Financial Accounting Standard
<b>FASB</b>	Financial Accounting Standards Board
<b>IAS Regulation</b>	Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19.7.2002 regarding the introduction of IFRS in the EU
<b>IASB</b>	International Accounting Standards Board
<b>IFRS</b>	International Financial Reporting Standards
<b>MoU</b>	Memorandum of Understanding signed by the FASB and the IASB on February 27, 2006 on convergence
<b>SARG</b>	Standards Advice Review Group
<b>SEC</b>	Securities and Exchange Commission
<b>TEG</b>	Technical Expert Group of EFRAG
<b>US</b>	Unites States of America
<b>US GAAP</b>	United States Generally Accepted Accounting Principles
<b>UK</b>	United Kingdom

**ANNEX 1: QUESTIONNAIRE**

**Questionnaire**

**EFFECT STUDY ON REVISED IAS 23 *BORROWING COSTS***

Please provide the following details together with your response:

- Preparer                       User                       Other (please specify) \_\_\_\_\_

Name of your organization / company

Short description of the general activity of your organization/ company

Country where your organization/ company is located

Contact details incl. e-mail address

Please indicate whether you submitted comments to IASB and/or EFRAG during their consultations on exposure drafts, comment letters or endorsement advice related to the revised IAS 23:

- Yes                       No

In case we need further details on the submitted information we will take the liberty to contact the relevant respondent.

*Information from preparers*

Markets where your company is listed:

- European Union                       US                       Others (please specify) \_\_\_\_\_

Size on group level:

Total assets \_\_\_\_\_                      Revenues \_\_\_\_\_  
Employees \_\_\_\_\_



## 1. General questions on IAS 23

a) Which method do you think will provide more relevant, reliable, comparable and understandable information?

Relevant  Capitalising  Expensing

Reliable  Capitalising  Expensing

Comparable  Capitalising  Expensing

Understandable  Capitalising  Expensing

b) Can you explain the reasons why you prefer one or the other method?

c) Do you think higher comparability will be achieved between companies through the removal of the expensing method?

d) What do you consider are the main costs and benefits of the revised IAS 23 and what weighting would you assign to each of them?

## 2. Questions for preparers

a) Can you explain how significant IAS 23 is for your business?

Significant  Not significant

Please provide us with an explanation of your answer.

b) Are you currently expensing or capitalising your borrowing costs?

Expensing

Capitalising

Comments:

c) Can you provide reasons for why your company has chosen to use the expensing or the capitalization method?

d) Can you describe what changes your company made in the past or will have to make in order to change from expensing to capitalizing borrowing costs?

e) Can you give a qualitative and quantitative estimation of the costs involved in applying the capitalisation method? Please distinguish between implementation costs and recurring costs if possible.

f) Can you describe the main problems you have encountered/believe you will encounter in applying the capitalization method and their significance?

## 3. Questions for users

a) Can you explain what kind of information related to borrowing costs you need in order to make your analysis?

b) Can you explain how the capitalization of borrowing costs impacts on your financial analysis?

c) Do you believe the elimination of one option will make financial reports more comparable for your analysis?

#### **4. Other Questions**

a) Can you provide any information that has been generated by field studies, research work, internal analysis carried out in your organization, jurisdiction?

b) If you have any further comments on this consultation please provide them to us.

## ANNEX 2: LIST OF COMMENTATORS

No	Organisation/name	Country	Field	Description
1	AFRAC	Austria	Accountants and auditors	Accountants and auditors
2	Bank Austria Creditanstalt	Austria	Preparers	Bank
3	KPMG (Austria)	Austria	Accountants and auditors	Accountants and auditors
4	UNIQA	Austria	Preparers	Insurance
5	Nestle	Switzerland	Preparers	Producer
6	Roche	Switzerland	Preparers	Healthcare
7	Chamber of Auditors of the Czech Republic	Czech Republic	Accountants and auditors	Accountants and auditors
8	Accounting Standards Committee of Germany	Germany	Public authorities	Standard setter
9	LBBW - Landesbank Baden-Wurtemberg	Germany	Users	Bank
10	AP Moller-Maersk Group	Denmark	Preparers	Shipping
11	ARLA Foods	Denmark	Preparers	Dairy cooperative
12	ASETA	Spain	Association of preparers	Services
13	ENDESA	Spain	Preparers	Energy
14	Grup Cassa	Spain	Preparers	
15	ICAC	Spain	Public authorities	Standard setter
16	Red Eléctrica de España	Spain	Preparers	Services
17	REGA	Spain	Accountants and auditors	Accountants and auditors
18	Sacyr Vallehermoso	Spain	Preparers	Construction
19	SEOPAN	Spain	Association of preparers	Construction
20	UNESA	Spain	Association of preparers	Energy
21	Union Fenosa Group	Spain	Preparers	Energy
22	FEE	EU	Accountants and auditors	Accountants and auditors
23	ACTEO, AFEP, MEDEF	France	Association of preparers	Companies organisation
24	Banque Populaire	France	Preparers	Bank
25	Compagnie de Saint-Gobain	France	Preparers	Producer
26	Unicredit	Italy	Preparers	Bank
27	Dutch Accounting Standards Board (DASB)	Netherlands	Public authorities	Standard setter
28	Ministry of Economy and Finance (Romania)	Romania	Public authorities	Standard setter
29	ACCA	United Kingdom	Accountants and auditors	Accountants and auditors
30	Accounting Standard Board UK (ASB)	United Kingdom	Public authorities	Standard setter
31	ICAEW	United Kingdom	Accountants and auditors	Accountants and auditors
32	LIBA - London Investment Banking Association	United Kingdom	Users	Bank
33	PriceWaterhouseCoopers (PWC)	United Kingdom	Accountants and auditors	Accountants and auditors
34	QCA - Quoted Companies Alliance	United Kingdom	Association of preparers	Companies organisation