Grant Thornton

Capitalisation of borrowing costs

From theory to practice
April 2009

Introduction

The International Accounting Standards Board (IASB) issued a revised version of IAS 23 *Borrowing Costs* (IAS 23) in March 2007. In the revised standard, the previous benchmark treatment of recognising borrowing costs as an expense has been eliminated. Instead, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset will form part of the cost of that asset. The revised IAS 23 is effective for annual periods beginning on or after 1 January 2009 with earlier application permitted.

The new standard will represent a change in accounting policy for entities that applied the benchmark treatment under the previous standard. These entities will now need to develop procedures to calculate the amount of borrowing costs to be capitalised. Although the concept of capitalising borrowing costs is simple and familiar to many, putting that concept into practice frequently leads to questions. Issues that often take up management time, and may therefore need to be considered early, include:

- which of the entity's loans are specific borrowings?
- how does an entity reflect the fluctuation of borrowings and interest rates during the period when calculating the borrowing costs to capitalise?
- how does an entity take into account the effects of exchange differences in determining the amount of borrowing costs to capitalise?

These and many other common questions are considered in this guide: *Capitalisation of borrowing costs - from theory to practice* (the guide).

The member firms of Grant Thornton International Ltd (Grant Thornton International) - one of the world's leading organisations of independently owned and managed accounting and consulting firms - have gained extensive insights into the more problematic aspects of IAS 23. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS and is therefore pleased to share these insights by publishing this guide. The guide reflects the collective experience of Grant Thornton International's IFRS team and member firm IFRS experts.

Using this guide

The guide is arranged in a 'question and answer' format to address the questions that we encounter most frequently. The guide also includes several examples illustrating the capitalisation of borrowing costs.

Before moving on to the specific application guidance, **section A** presents an executive summary of IAS 23 and a summary flowchart to illustrate the main concepts.

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The guide looks then at the scope and definitions in IAS 23 (**section B),** while **Section C** deals with determining the amount of borrowing costs to be capitalised. **Section D** deals with frequently asked questions about the period of capitalisation, in other words when capitalisation begins and when it ends. Group situations, which can give rise to complex application issues, are discussed in **section E**.

Section F deals with the transitional provisions - both for existing preparers with a previous policy of expensing borrowing costs and also for first-time adopters.

The guide is intended to assist companies and auditors in applying IAS 23. We have not attempted to cover every aspect of IAS 23. However, we believe this guide will help in addressing the problems most often encountered in practice.

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Contents

	Page
A: IAS 23 in brief	**4**
IAS 23 decision tree - summary	5
Executive summary	6
B: Scope and definitions	**7**
Scope	7
Definition of borrowing costs	7
Cost of equity instruments	8
Definition of a qualifying asset	9
Assets measured at fair value	10
Exemption for certain types of inventories	12
C: Borrowing costs to be capitalised	**14**
Specific borrowings for a qualifying asset	14
General borrowings	16
Qualifying assets financed by a combination of general and specific borrowings	21
Exchange differences	22
Derivative gains or losses	24
Other practical issues	26
D: Period of capitalisation	**28**
Commencement of capitalisation	28
Suspension of capitalisation	30
Cessation of capitalisation	31
E: Group situations	**33**
Separate and individual financial statements	33
Consolidated financial statements	35
F: Effective date and transition	**38**
Existing preparers with a previous policy of expensing borrowing costs	38
First-time adopters	39

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A: IAS 23 in brief

A revised version of IAS 23

IAS 23 *Borrowing Costs* (IAS 23) addresses accounting for borrowing costs. It considers whether borrowing costs should be capitalised as part of the cost of the asset, or expensed in profit or loss.

The previous version of IAS 23 permitted a choice in accounting for borrowing costs. The benchmark treatment was to expense all borrowing costs. The alternative treatment allowed capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset.

As part of the IASB's efforts to seek convergence with US GAAP a revised version of IAS 23 was issued in March 2007. The revised version requires (rather than permits) the capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. The Board concluded that recognising borrowing costs as an expense immediately does not give a faithful representation of the cost of an asset (IAS 23.BC9). This new approach achieves convergence in principle with US GAAP (SFAS 34), although some detailed differences of application will remain.

The new benchmark treatment in the revised version of IAS 23 becomes mandatory for accounting periods beginning on or after 1 January 2009.[1] For entities with a previous policy of expensing borrowing costs the standard sets out transitional provisions which should reduce the cost and complexity of changing accounting policies (where required).

On the following pages a decision tree of the requirements of IAS 23 is presented together with an executive summary.

Capitalisation of borrowing costs has been discussed for a number of years. Some commentators argue that expensing borrowing costs reduces comparability between purchased assets and constructed assets, because the price of a purchased asset would include the seller's borrowing costs incurred during construction. Others argue that the capitalisation of borrowing costs is not useful, for example because two entities constructing identical assets may capitalise different amounts depending on their capital structure.

[1] IAS 23 Borrowing Costs (Revised 2007) was endorsed for use in the European Union in December 2008.

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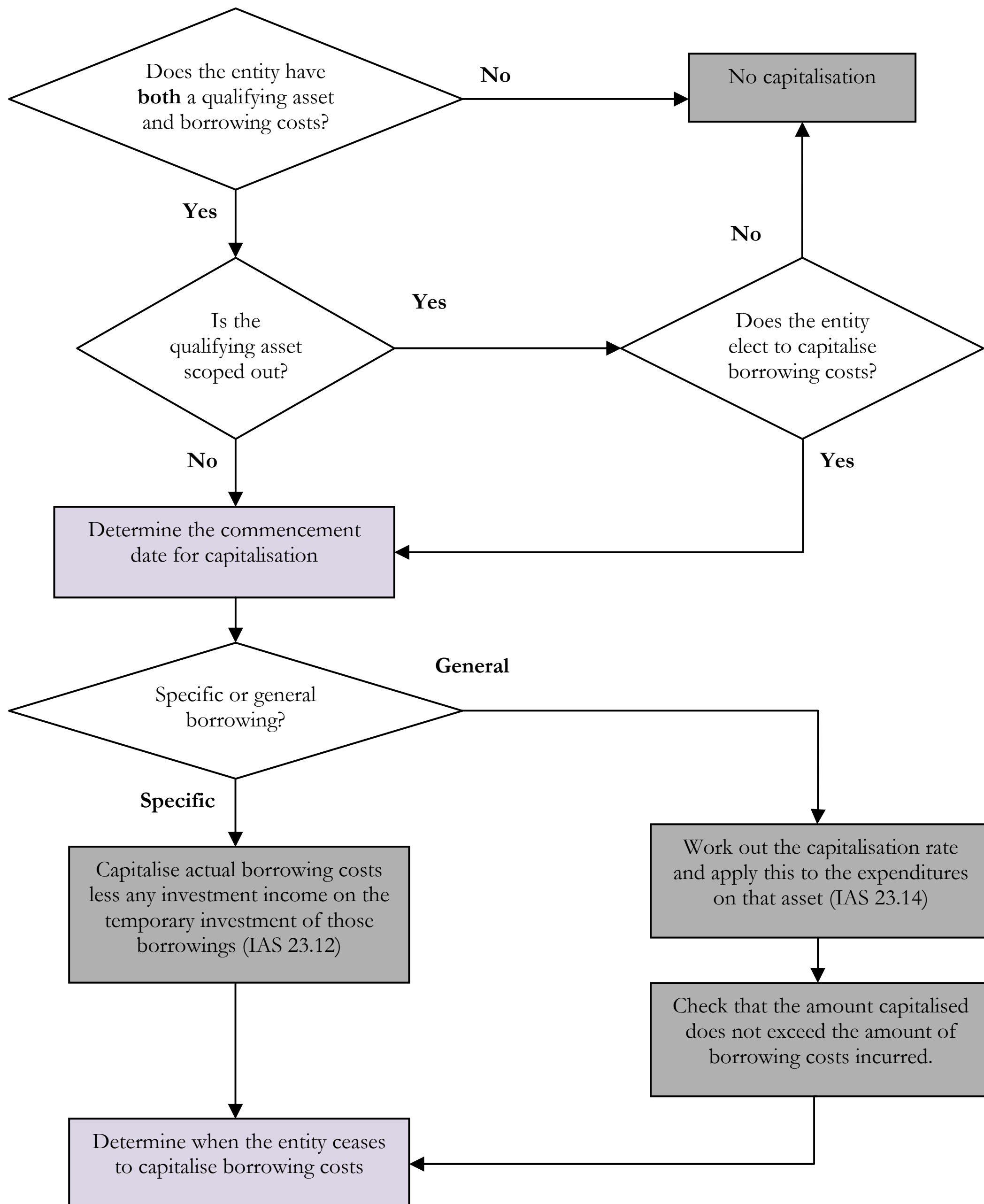
IAS 23 decision tree - summary

How do you determine the amount of borrowing costs to be capitalised? The purpose of the following diagram is to summarise the main requirements of the standard and to illustrate the route which preparers need to follow to determine the treatment of borrowing costs.



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Executive summary

A. IAS 23 addresses accounting for borrowing costs.

B. Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs may include interest expense calculated using the effective interest method, finance charges in respect of finance leases and certain exchange differences from borrowings denominated in a foreign currency.

C. If, and only if, an asset meets the definition of a qualifying asset then borrowing costs incurred are capitalised as part of its cost (unless a scope exception applies). A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. The standard excludes certain qualifying assets from its scope.

D. The core principle of the standard is that only those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised. All other borrowing costs are expensed as incurred.

E. Borrowing costs that satisfy the 'directly attributable' criterion are generally those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. Borrowing costs are not always readily attributable to a qualifying asset. This may be the case where an entity borrows funds generally. The standard includes guidance on how to allocate borrowing costs in such circumstances.

F. An entity begins to capitalise borrowing costs on the commencement date which is when three conditions are met: a) it incurs expenditures for the asset; b) it incurs borrowing costs for the asset; and c) it undertakes activities that are necessary to prepare the asset for its intended use or sale. An entity suspends capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

G. An entity ceases to capitalise borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

H. An entity is required to apply the standard for annual periods beginning on or after 1 January 2009. An entity starts capitalising borrowing costs only for those qualifying assets for which the commencement date is on or after 1 January 2009.

I. Entities are not required to apply the standard retrospectively. However, an entity may wish to apply the standard to qualifying assets for which the commencement date is before 1 January 2009. An entity is permitted to designate any date before 1 January 2009 and apply the standard to borrowing costs relating to all qualifying assets for which the commencement date is on or after that designated date.

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B: Scope and definitions

Scope

What is the scope of IAS 23?
The guidance in IAS 23 should be applied in accounting for borrowing costs (IAS 23.2). As a practical matter, entities are affected by IAS 23 only if they both incur borrowing costs and have one or more 'qualifying assets'. The actual or imputed cost of equity is not a borrowing cost and is not therefore addressed by IAS 23 (including the cost of preferred capital that is classified as equity).

IAS 23 includes two optional scope exemptions. It need not be applied to:

- assets measured at fair value; or
- certain inventories.

The scope exemptions are discussed below.

Definition of borrowing costs

The scope paragraph states that the standard should be applied in accounting for borrowing costs but what is the definition of borrowing costs?
Borrowing costs are defined as interest and other costs that an entity incurs in connection with the borrowing of funds (IAS 23.5). Borrowing costs may include items such as interest expense calculated using the effective interest method, finance charges in respect of finance leases and some exchange differences arising from foreign currency borrowings (IAS 23.6).

IAS 23.6:
"Borrowing costs **may** include:

(a) **interest expense** calculated using the effective interest method as described in IAS 39;

(d) **finance charges** in respect of finance leases recognised in accordance with IAS 17;

(e) **exchange differences** arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs." [emphasis added]

The definition is relatively broad and, therefore, other types of finance costs may also be considered borrowing costs.

Is the list in IAS 23.6 exhaustive in its catalogue of borrowing costs?
No. Generally, IAS 23.6 gives examples of costs that may be included in borrowing costs. As stated in the definition of borrowing costs, both interest and other costs can meet the definition. Accordingly, it is often necessary to use judgement to establish which finance costs are within the definition.

What types of costs are eligible for capitalisation?

The definition of borrowing costs is broad. Therefore, questions often arise as to what types of costs are eligible for capitalisation. These application issues are discussed further in section C.

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Are there any differences in the list of borrowing costs in IAS 23.6 compared to the previous version of IAS 23?

Yes. Paragraph 6 was amended by *Annual Improvements to IFRSs* released in May 2008 and the amendment is effective on the same date as the standard (1 January 2009), meaning that entities adopting IAS 23 (revised) should apply the amended paragraph. After the amendments, the concept of interest expense in paragraph 6 is now aligned to the effective interest method in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). As a result the references to 'ancillary costs' and 'amortisation of discounts or premiums' have been removed from the list, as they will often be included in the calculation of interest expense in accordance with the effective interest method.

What types of costs are included in the effective interest method under IAS 39?

The effective interest method takes account of all fees and points paid or received that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts (IAS 39.9). The effective interest method is used where a financial liability is accounted for at amortised cost under IAS 39 (most loans in practice). The result of applying this method is to allocate interest expense over the relevant periods by producing a periodic interest expense equal to a constant percentage of the carrying amount of the liability. This means that transaction costs and fees are in effect amortised over the life of the loan and are included in the interest expense. IAS 39 includes further guidance on the application of the method in IAS 39.AG5-8.

Cost of equity instruments

Is the 'cost of equity' such as, for example, dividends within the scope of the standard?

No. The standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability (IAS 23.3). Accordingly, where a financial instrument has been classified as equity in accordance with IAS 32 *Financial Instruments: Presentation* (IAS 32) the costs of servicing the equity instrument cannot be capitalised. Rather, these costs are charged to equity in accordance with IAS 32.36.

Because 'cost of equity' is **not** capitalised, comparability between assets is **only** achieved for those assets that are financed with borrowings (not those financed with equity or by a combination of both).

An entity's capital structure may therefore affect the reported cost of a qualifying asset.

On the other hand, if the instrument is classified as a liability, the costs in connection with servicing the liability are generally within the scope of the standard (and may be capitalised). Classification of an instrument as either equity or liability can be a complex issue and is not discussed in this publication.

Are interest expenses on a compound financial instrument within the scope of the standard?

Yes. A compound financial instrument is divided into an equity component and a liability component. Therefore, the interest expense on the liability component, calculated in accordance with the effective interest method, should be considered part of borrowing costs.

Some compound instruments may feature payment of dividends in relation to the equity component at the discretion of the issuer (in addition to interest on the liability). Such dividends are charged to equity as a distribution and are not within the scope of IAS 23.

The entity has issued preference shares that are redeemable at the option of the holder. Are dividends paid on the shares within the scope of the standard?

Yes. A preference share that provides for redemption at the option of the holder is generally a financial liability in accordance with IAS 32. Dividend payments on shares classified as a liability are recognised in profit or loss in the same way as interest on a bond (IAS 32.36). The dividend payments are therefore within the scope of IAS 23 (IAS 23.3) and may need to be capitalised.

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Definition of a qualifying asset

What is a 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 (IAS 23.5).

The definition of a qualifying asset is key for the capitalisation principle

In this section we look at what types of assets are a qualifying asset. This is important, as an asset **must** meet the definition of a qualifying asset in order for borrowing costs to be capitalised as part of the carrying amount of that asset. Borrowing costs are immediately expensed if they are not incurred to acquire, construct or produce a qualifying asset.

Determining if an asset is a qualifying asset will depend on the circumstances and requires the use of judgement in each case. However the following assets cannot be a qualifying asset: (i) financial assets, (ii) assets that are ready for their intended use or sale when acquired, and (iii) inventories that are manufactured, or otherwise produced, over a short period of time (IAS 23.7).

IAS 23.7:
"Depending on the circumstances, any of the following **may** be qualifying assets:

(a) inventories
(b) manufacturing plants
(c) power generation facilities
(d) intangible assets
(e) investment properties.

Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets."
[emphasis added]

Is IAS 23.7 an exhaustive list of qualifying assets?
This list is not exhaustive. The items listed are examples of what may be a qualifying asset.

Can internally developed intangible assets be a qualifying asset?
Yes. IAS 23 does not exclude internally developed intangible assets from the definition of a qualifying asset. An example of a qualifying intangible asset could be internally developed software produced over a substantial period of time.

A qualifying asset takes a substantial period of time to get ready for its intended use or sale. Does the standard include a quantitative definition of a 'substantial period of time'?
No. Management considers the facts and circumstances and uses its judgement to determine whether an asset takes a substantial period of time to get ready for its intended use or sale.

Should management's intention be taken into account when it determines whether the asset is a qualifying asset?
Yes. The standard clearly states that an asset is assessed based on its intended use or sale (see definition of a qualifying asset in IAS 23.5). Accordingly, alternative uses are not taken into account when management evaluates an asset. To illustrate the application of this principle, consider the following example:

Property acquired for development

A property developer acquires a property, which management intends to develop into luxury apartments.

Alternatively, the property could be sold or leased immediately after its acquisition.

Should management's intention be taken into account?

Yes. Assessing whether an asset is a qualifying asset takes into consideration its intended use. The property is determined to be a qualifying asset because management intends to develop the asset over a substantial period of time. This is not changed by the fact that the property could alternatively be sold immediately.

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An asset might be acquired in a finished state, but its intended use is as a part of a larger group of integrated assets. Can the acquired asset be a qualifying asset?
The acquired asset might be a qualifying asset while activities on the larger project are under way. For example, an entity constructing a new factory might take delivery of air-conditioning units during the construction period. The air-conditioning units might be qualifying assets even if they are substantially complete when considered in isolation. This is because they might not be ready for their intended use until the factory project as a whole is substantially complete.

Assets measured at fair value

When a qualifying asset is measured at fair value, should borrowing costs still be capitalised?
This is an option. IAS 23.4(a) states that an entity is not required to apply the standard to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value.

Effectively this means that an entity can make an accounting policy choice of capitalising borrowing costs for assets measured at fair value. Capitalisation will not affect the carrying value of the asset in question (as this is fair value) but will affect the presentation of borrowing costs and fair value movements - see examples on page 11. The chosen policy should be applied consistently and disclosed in the notes if significant.

The exemption in IAS 23.4 does **not** mean that assets measured at fair value cannot be qualifying assets. Rather, it states that an entity **does not have to** capitalise borrowing costs for such assets. This recognises the fact that the measurement of such assets will not be affected by the amount of borrowing costs capitalised.

Can the exemption for assets measured at fair value be applied for assets where gains or losses are recognised in other comprehensive income?
Yes. IAS 23 states that all assets measured at fair value are included in the exemption. Therefore, borrowing costs are not required to be capitalised (it is an accounting policy choice) for assets measured at fair value with gains or losses recognised in other comprehensive income, such as property, plant and equipment accounted for in accordance with the revaluation model in IAS 16 *Property, Plant and Equipment*.

After a recent amendment, investment property under construction can now be measured at fair value. Should borrowing costs for investment property under construction be capitalised?
Whether borrowing costs are capitalised will depend on the entity's accounting policy for investment property under construction. IAS 40 *Investment Property* (IAS 40) was amended by *Annual Improvements 2008* to permit investment property under construction to be measured at fair value (for accounting periods beginning on or after 1 January 2009).

Where investment property under construction is measured at **fair value** entities are not required to capitalise borrowing costs but, as noted above, they may choose to do so (IAS 23.4(a)). Where the **cost** option is chosen, entities are required to capitalise borrowing costs for investment property under construction (assuming IAS 23's other conditions are met).

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What is the effect of capitalising (or not capitalising) borrowing costs for assets measured at fair value?

This affects the presentation of borrowing costs and fair value movements within profit or loss and other comprehensive income. The value of the asset remains the same. The effect is best illustrated by considering the following two examples:

Investment property under construction measured at fair value

An entity develops property that will be investment property. In accordance with the amended version of IAS 40 *Investment Property* the entity can choose to measure the property under construction at fair value with gains and losses recognised in profit or loss. At the end of the reporting period the fair value of the property is CU 1,000. Costs incurred at the end of the reporting period amount to CU 900, including borrowing costs of CU 50.

Scenario 1: Entity does not capitalise borrowing costs
The entity recognises borrowing costs directly attributable to the property in profit or loss. The cost of the property excluding borrowing costs is CU 850. The entity recognises a fair value gain in the income statement of CU 150. The total effect on profit or loss is CU 100 (fair value gain of CU 150 less borrowing costs of CU 50).

Scenario 2: Entity capitalises borrowing costs
The entity capitalises borrowing costs directly attributable to the property as part of the cost of the asset. The cost of the property at the end of the period is CU 900. The entity recognises a fair value gain in profit or loss of CU 100. The total effect on profit or loss is CU 100.

The asset is measured at CU 1,000 in both scenarios. The effect on profit or loss is CU 100 in both scenarios. If the entity elects to capitalise borrowing costs, the only effect is a reallocation between interest expense and the fair value gain.

Owner-occupied property under construction measured at fair value in accordance with the revaluation model of IAS 16

An entity constructs a property that is intended for own-use as its head office building. It chooses to measure the property at revalued amount being its fair value, in accordance with IAS 16 *Property, Plant and Equipment.*

At the end of the reporting period the fair value of the property is CU 1,000. Costs incurred at the end of the reporting period amount to CU 900, including borrowing costs of CU 50.

Scenario 1: Entity does not capitalise borrowing costs
The entity recognises borrowing costs directly attributable to the property in profit or loss. The cost of the property excluding borrowing costs is CU 850. The entity recognises a fair value gain in other comprehensive income of CU 150. The total effect is an interest expense in profit or loss of CU 50 and a fair value gain in other comprehensive income of CU 150.

Scenario 2: Entity capitalises borrowing costs
The entity capitalises borrowing costs directly attributable to the property as part of the cost of the asset. The cost of the property at the end of the period is CU 900. The entity recognises a fair value gain in other comprehensive income of CU 100. The borrowing cost of CU 50 is excluded from the interest expense in profit or loss.

The asset is measured at CU 1,000 in both scenarios. The accounting policy choice affects profit or loss and other comprehensive income. Total comprehensive income is unaffected.

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Exemption for certain types of inventories

Are borrowing costs required to be capitalised if they relate to inventories within the scope of the exemption?
No. This is an option. The scope exemption in IAS 23.4(b) means that preparers are allowed an accounting policy choice in respect of borrowing costs directly attributable to those inventories. The requirements are summarised in the box below:

The exemption in IAS 23.4(b) does not mean that those inventories cannot be qualifying assets. Rather, it states that an entity **does not have to** capitalise borrowing costs for inventories that are manufactured, or otherwise produced, in **large quantities** on a **repetitive** basis.

The exemption acknowledges the difficulties in allocating and monitoring borrowing costs for such inventories. The US standard also recognises these difficulties for certain types of inventories.

Capitalisation of borrowing costs for inventories

Main rule for all inventories
If the inventory is a qualifying asset, the entity is generally required to capitalise borrowing costs (IAS 23.7(a) and IAS 23.8).

Exception for certain inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis:
This is an accounting policy choice (IAS 23.4(b)). Entities can elect not to capitalise borrowing costs - but only for those inventories within the scope of the exemption.

For inventories within the scope of the exemption, the chosen policy should be consistently applied and disclosed if significant. The exemption is likely to benefit many entities that produce 'standard' inventories in large quantities (see also IAS 23.BC6).

What types of inventories qualify under the exemption in IAS 23.4(b)?
IAS 23 does not give examples of assets that are covered by this exemption. Hence judgement will be required to determine whether the exemption applies in specific circumstances. Factors to consider include the production volume and the extent to which items are produced to a standard design. 'Standard items' may be exempted even if they are high value and require substantial time to produce (such as aircraft).

The exemption is relevant only to inventories that meet the definition of qualifying assets in the first place. Inventories that are produced in a short period of time are not qualifying assets and are therefore outside the scope of IAS 23.

What are 'large quantities' for this purpose?
IAS 23 does not set out a quantitative threshold and judgment is required. As noted above, we believe that aircraft that are produced as a standard item in large quantities (several hundred) may qualify under the exemption.

Where an asset is built to order it becomes difficult to argue that the inventories are produced in large quantities. An example would be a non-standardised ship that is manufactured to the highly specialised requirements of the customer. In our opinion, such an asset would normally not qualify under the exemption, because it is not produced in large quantities or on a repetitive basis.

Are residential houses within the scope of the exemption?
Some house-builders undertake high volume developments based on one or more standard designs. Others may design each house or housing development as a 'one-off'. We believe that it may be appropriate to apply the exemption in some cases but judgement is required based on specific facts and circumstances.

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Some food and drink products require a substantial period of time to get ready for use or sale, because they require ripening/maturation. Does the exemption apply for such assets?

Examples of food and drink products that can require a substantial period of time include cheese, wine and whisky. Such assets may qualify under the exemption. However, management must demonstrate in each case that inventories are being produced in large quantities on a repetitive basis (IAS 23.4(b)). Where these conditions are satisfied, the entity has an accounting policy choice of whether or not to capitalise borrowing costs.

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C: Borrowing costs to be capitalised

How do you determine the amount of borrowing costs to be capitalised?

Once the entity has determined it has both qualifying assets (that are not scoped out) and borrowing costs, the entity needs to work out how much to capitalise. In this section we look at how to determine the amount of borrowing costs to capitalise. The application of IAS 23 in this area can be difficult and often requires the use of judgement.

The basic principle is that 'directly attributable' borrowing costs are those costs that would have been avoided if the expenditure on the qualifying asset had not been made. To put this principle into practice, it is usually necessary to determine:

- one or more capitalisation rates,
- the applicable expenditures on qualifying assets to which to apply these rates, and
- the total amount of borrowing costs in each period.

An important distinction is made between specific and general borrowings. Entities may wish to borrow funds generally rather than for specific qualifying assets. In those situations it becomes more difficult to identify a relationship between the loan and the qualifying asset. Therefore some judgement is often necessary to determine what to include in borrowing costs and how much to capitalise. This section answers common questions in this area, and also considers whether borrowing costs may include derivative gains or losses, exchange differences and other items that may be viewed as finance-related.

Specific borrowings for a qualifying asset

How is a loan determined to be a 'specific borrowing'?
A specific relationship is normally identifiable. For example, an entity may be able to demonstrate that a loan is for the purpose of the construction of a building based on negotiations with the lender, its actual use of the loan proceeds, its internal documentation of the purpose or the contractual terms of the loan (such as use covenants in the loan agreement). In some cases a group entity might be established to undertake a single development project and may borrow funds directly for that exclusive use.

In our view, it is not necessary to demonstrate a contractual link between a borrowing and a qualifying asset.

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IAS 23.12:

"To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the **actual** borrowing costs incurred on that borrowing during the period **less** any investment income on the temporary investment of those borrowings." [emphasis added]

How are borrowing costs eligible for capitalisation determined for a specific borrowing?

The borrowing costs eligible for capitalisation in respect of a specific borrowing are the **actual** borrowing costs incurred on that borrowing during the period (IAS 23.12). As the borrowing is being used directly to finance the qualifying asset, the amount of borrowing costs that could have been avoided is the actual borrowing cost. The borrowing costs are capitalised only while the asset in question is a qualifying asset and only during the capitalisation period.

Specific borrowings

For specific borrowings the entity applies the principles in IAS 23.12 to determine the borrowing costs to be capitalised in relation to a qualifying asset.

An entity has issued a loan for the construction of a specific qualifying asset. The full amount is not needed immediately for expenditures on the qualifying asset and part of the proceeds are temporarily re-invested in a cash deposit. Should the entity reflect the investment income in the amount of borrowing costs to be capitalised?

Yes. IAS 23.12 requires eligible borrowing costs to be measured as actual borrowing costs on the specific borrowing less any investment income earned on the temporary investment of the specifically borrowed funds.

Where the excess funds are invested temporarily investment income is deducted from the actual borrowing costs.

Excess funds have been invested temporarily in non-cash investments. How is investment income defined - does it also include gains on temporary investments (or similar)?

In most situations, the excess funds will be invested in short-term cash deposits (or similar) to avoid the risk of change in value. However, the investment income 'add-back' is not limited to income from cash deposits. Accordingly, where the excess funds are placed temporarily in other investments such as bonds or shares, a question arises as to whether investment income includes gains on these investments as well as interest and dividends (for example a gain attributable to exchange differences or an increase in the value of the security invested in). The standard uses the term 'any investment income' and, accordingly, we do not believe the inclusion of items other than interest is prohibited. Rather, it is an accounting policy choice.

However, where funds are invested in a speculative manner (such as in high-risk equities), this may call into question whether the loan is genuinely specific to a qualifying asset. In such cases the proceeds are being used for other purposes. Furthermore, in our view it is not acceptable to:

- capitalise investment losses - investment income can only reduce the amount of borrowing costs to be capitalised and accordingly losses from investments may not be capitalised,
- capitalise a negative amount in (rare) situations where investment income exceeds borrowing costs.

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Funds are temporarily used for the entity's working capital while awaiting expenditure on the qualifying asset. Is the entity required to deduct a 'notional' investment income as if it had invested the amount?
No. Investment income does not include 'notional interest' on funds that are used to finance working capital for a temporary period - only actual investment income is deducted.

A question arises as to whether the entity should in these circumstances capitalise the full amount of borrowing costs on the specific borrowing (including borrowing costs for funds used for the entity's working capital). In our view, only the amount of borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made is capitalised. In other words, the amount of borrowing costs eligible for capitalisation is limited by the actual expenditures on the asset to date. This is consistent with the principle of IAS 23.13. To illustrate, consider the following example:

Funds temporarily invested in working capital

An entity constructs a single qualifying asset at a cost of CU 1,000. The commencement date is 1 February 20X1. The payments for construction of the qualifying asset are as follows:
- 1 February 20X1: CU 200
- Payment on completion at 31 December 20X1: CU 800.

The entity takes out a loan of CU 1,000 (equivalent to total cost) on 1 February 20X1. On this date CU 200 is paid. During the 11 month period until completion, the remaining proceeds from the loan (CU 800) are used to finance working capital. Interest is charged on the loan at 10%, amounting to CU 92 for the 11 months.

Is the full amount (CU 92) capitalised as part of the cost of the asset for 20X1?
No. Only the amount of borrowing costs that would have been avoided if the entity had not made expenditures on the qualifying asset are capitalised. This is equivalent to 10% of CU 200 for 11 months. The borrowing costs incurred for the rest of the loan could have been avoided by the entity. Borrowing costs incurred on the rest of the loan are reflected in profit or loss (as there are no other qualifying assets). Had the entity not been able to use the funds from the specific borrowing, it would have been required to obtain alternative funding for its working capital, which would have been recognised in profit or loss.

General borrowings

When do the rules for general borrowing of funds apply?
The rules for general borrowing of funds apply when an entity obtains a qualifying asset and does not obtain a specific borrowing for that purpose (IAS 23.14). Such a situation may occur when the financing activity of an entity is co-ordinated centrally (IAS 23.11) and the entity uses these funds for obtaining one or more qualifying assets.

How are borrowing costs on general borrowings attributed to qualifying assets?
The basic principle, of capitalisation of the amount that would have been avoided had the expenditure not been made, continues to apply. However, there are additional practical difficulties in determining this amount in the absence of a direct relationship between borrowings and qualifying assets.

IAS 23.14 specifies that the entity determines the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures for obtaining the qualifying asset. This is calculated using the weighted average of the borrowing costs applicable (numerator) to the borrowings of the entity that are outstanding during the period (denominator) (IAS 23.14).

Borrowings entered into specifically for the purpose of obtaining a qualifying asset, and the related borrowing costs, are not included in the calculation. However, borrowing costs on a loan that relates

IAS 23.14
"To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period"

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to a specific qualifying asset may form part of the pool of general borrowing costs if part of the loan proceeds is temporarily used for general purposes.

IAS 23.14 sets an upper limit for borrowing costs capitalised during a period. The amount capitalised should not exceed the amount of borrowing costs incurred during the period (IAS 23.14).

Capitalisation of borrowing costs for general borrowings

In order to determine the amount to be capitalised, a capitalisation rate is applied to the expenditures on the asset. Accordingly, the process involves calculating both a capitalisation rate and expenditures on the asset. An upper limit on the amount to be capitalised applies - this cannot exceed the amount of borrowing costs incurred during the period.

In contrast to IAS 23's requirements on specific borrowings, there is no reference to deducting investment income on temporarily invested proceeds from general borrowing costs. Is this permitted or required?
No. IAS 23 does not appear to envisage deducting investment income on temporarily invested proceeds from general borrowing costs. Accordingly, we do not believe it is acceptable to deduct investment income from general borrowing costs.

A reporting entity is a 50% venturer in a jointly controlled entity (JCE), for which it uses the proportionate consolidation method in its consolidated financial statements. Should the reporting entity include its share of the general borrowings (and costs) of the JCE in calculation of the group's capitalisation rate?
Yes. We believe the reporting entity's share of borrowings and borrowing costs of the JCE should be included. The entity's decision to apply the proportionate consolidation method means that its share of borrowings of the JCE are regarded as group borrowings.

An entity borrows funds specifically to acquire non-qualifying assets. Should the entity include this borrowing in determining the capitalisation rate?
Entities often borrow funds to obtain one or more **non-qualifying** assets. Consider the following examples:

Loan obtained to acquire a business
An entity acquires a business (accounted for in accordance with IFRS 3), which is a non-qualifying asset under IAS 23. For this purpose, the entity has taken out a loan specifically to finance the acquisition.

Finance lease of a non-qualifying asset
An entity enters into a finance lease agreement for a non-qualifying asset. Accordingly, the entity records a liability and incurs finance charges. Management can demonstrate that the lease has been used to obtain the leased asset (this would often be readily determinable from the lease agreement).

Borrowing to obtain an asset that is ready for its intended use or sale
An entity acquires a second-hand vessel. It is ready for its intended use when acquired and hence not a qualifying asset. For the purpose of obtaining the vessel the entity obtains a loan. Management can demonstrate that this loan was issued only to acquire the second-hand vessel.

In this situation, a question arises as to whether the loan taken out to acquire a non-qualifying asset is included in calculating the capitalisation rate. The issue is whether; (1) all borrowings other than specific borrowings for qualifying assets must be included in determining the capitalisation rate, or (2) whether other borrowings for other specific assets or purposes (but not qualifying assets) are also excluded.

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IAS 23.14 refers to borrowings of the entity less borrowings made specifically for the purpose of obtaining a qualifying asset. In our view this requires that all borrowings that are not specific to a qualifying asset are included. Put another way, if a borrowing is not taken out to acquire a specific qualifying asset, it is included in the 'pool' of general borrowings.

An alternative view is based on the first sentence of IAS 23.14 which states: "To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset.". Arguably, this implies that a borrowing is excluded from the calculation of the capitalisation rate if it is for a purpose other than obtaining a qualifying asset. However, we believe that the rest of IAS 23.14 does not support this alternative view.

This of course does not mean that all borrowing costs on general borrowings are capitalised. Rather, the effect of IAS 23.14 is that all borrowings that are not specific to a qualifying asset contribute to the capitalisation rate, and to the maximum amount of borrowing costs that may be capitalised.

To illustrate, consider the following example:

Funds borrowed specifically to acquire a non-qualifying asset

An entity has the following loans:

- CU 10 million loan with an interest rate of 9%. Management can demonstrate that this loan was taken out specifically to acquire a business (100% of the equity instruments of a subsidiary). The business was acquired for a purchase price of CU 10 million in cash. The loan was issued to the vendor as part of the purchase price.
- CU 2 million loan with an interest rate of 11%. The proceeds have been used to finance a combination of working capital, inventories and property, plant and equipment of which some items are qualifying assets. It can be demonstrated that the loan has not been used for the purpose of obtaining an individual qualifying asset.

Borrowing costs incurred during the year are CU 1,120,000 (CU 900,000 + CU 220,000).

Which loans are included in determining the capitalisation rate?
In our view both loans should be included. The capitalisation rate would be 9.33% (CU 1,120,000 / CU 12,000,000) and maximum borrowing costs to be capitalised would be CU 1,120,000.

An entity has some general borrowings. However, cash flows from operating activities are sufficient to fund the construction of a qualifying asset. Should the entity still capitalise borrowing costs?

Yes. In our view, it is not acceptable to conclude that all qualifying assets are financed with cash flows from operating activities if the entity has general borrowings. As noted above, we believe that IAS 23 treats loans as general borrowings to the extent they are not specific for the purpose of a qualifying asset.

The effect is broadly that qualifying assets are regarded as debt-financed if the entity has debt. Put another way, the qualifying assets are presumed to have 'first claim' on the proceeds of the entity's general borrowings.

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Can management claim that funds are borrowed specifically to finance working capital?
No. In our view, such a working capital loan is part of the 'pool' of general borrowings (see discussion in the preceding questions).

Are trade payables a general borrowing?
It depends. If no interest is paid on trade payables (or recognised in accordance with IAS 39), there are no costs or borrowings to include in the calculation of the capitalisation rate. However, we believe that where trade payables are a financing arrangement and interest is recognised, the entity should include trade payables in the calculation (if not used for a specific qualifying asset).

The expenditures on the asset occur unevenly during a period. How does the entity determine the expenditures on the asset?
IAS 23.18 states that the average carrying amount of the qualifying asset during the period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period. In some situations, however, a more detailed calculation may be appropriate (such as a weighted average of the expenditures or carrying amount). A more detailed calculation may be necessary to take account of the timing of expenditures during the period where these have occurred unevenly.

To illustrate, consider the following example:

Expenditures on the asset

	Additions CU	Carrying amount CU	Weighted average	Expenditure on the asset (weighted average carrying amount)
1 January 2009	-	200,000	3/12	50,000
1 April 2009	400,000	600,000	4/12	200,000
1 August 2009	300,000	900,000	3/12	225,000
1 November 2009	600,000	1,500,000	2/12	250,000
31 December 2009	-	1,500,000		725,000

If the entity had taken the average based on the opening and closing carrying amount, expenditure on the asset would have been calculated as CU 850,000. This may not be a reasonable approximation.

Where the asset is measured at fair value in the statement of financial position, it is not appropriate to use the average carrying amount (ie average fair value). IAS 23 does not deal with this situation. However, we believe it is appropriate to use the average cost of the asset in the period.

Borrowings of an entity may fluctuate substantially during a period. Interest rates also vary if the entity has floating rate loans. How does the entity reflect the fluctuation of borrowings and borrowing costs when calculating the capitalisation rate?
IAS 23.14 states that the entity should use a weighted average of the borrowing costs applicable to the outstanding borrowings of the entity during the period to work out a capitalisation rate. The calculation is not addressed in more detail. However, we believe that the method should reflect any significant fluctuation in borrowings and interest rates during the period. Calculating the capitalisation rate by using a 12 month-average will not always be appropriate. To illustrate the application, consider the following example:

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Capitalisation rate

An entity constructs a property, which is a qualifying asset. Funding is provided from the entity's general borrowings. Capitalisation of borrowing costs commences on 1 July 2009 and continues throughout the year until expected completion in 2010.

The entity has calculated that the weighted average of expenditures on the asset is CU 2,050,000.

The entity's general borrowings in the period 1 July 2009 to 31 December 2009 consist of the following:

a) CU 5 million bond with a fixed quarterly interest of 10%. The loan matures in 2015.
b) Bank loan of CU 2 million with a floating interest rate that is adjusted quarterly by changes in LIBOR. At 1 July 2009 interest was set at 8.75% which increased to 9.00% at 1 October 2009. The loan is paid off in quarterly instalments of CU 200,000 until it matures at 1 January 2012.
c) Bank overdraft with a floating interest rate that is adjusted by changes in LIBOR. Interest at 1 July 2009 is 14%, which was adjusted to 14.25% at 1 October 2009. The overdraft at 1 July 2009 was CU 300,000 which increased to CU 700,000 at 1 October 2009.

	Borrowings CU	Interest CU	Weighted average	Weighted average borrowings CU
Bond - 10% interest for 6 months	5,000,000	250,000	6/6	5,000,000
Bank loan paid off quarterly:				
- 8.75% interest July to September	2,000,000	43,750	3/6	1,000,000
- 9.00% interest October to December	1,800,000	40,500	3/6	900,000
Bank overdraft				
- 14% interest July to September	300,000	10,500	3/6	150,000
- 14.25% interest October to December	700,000	24,938	3/6	350,000
Total		**369,688**		**7,400,000**

Borrowing costs for the entity's general borrowings have been calculated as CU 369,688 (this is the maximum amount available for capitalisation). Fluctuations in interest rates and borrowings have been taken account of since interest expenses are calculated on the current borrowings.

The weighted average borrowings for the period have been calculated, in which the fluctuations are taken account of.

The capitalisation rate for the period is calculated using the borrowing cost in the period divided by the weighted average borrowings for the period.

$$\frac{\text{general borrowing costs}}{\text{weighted average general borrowings}} = \frac{369{,}688}{7{,}400{,}000} = 4.996\%$$

The capitalisation rate can be converted to an annual rate of 9.992% (4.996% × 2). This percentage appears reasonable given the entity's interest rates.

The total amount of borrowing costs eligible for capitalisation is found by applying the capitalisation rate to the expenditures of the asset (this is less than the maximum amount available for capitalisation).

$$9.992\% \times 6/12 \times 2{,}050{,}000 = 102{,}418$$

Does a loan previously deemed as specific for a qualifying asset become a general borrowing when borrowing costs ceased to be capitalised for that qualifying asset?

Yes. In our opinion, if a loan is deemed to be specific for the purpose of obtaining a qualifying asset, that loan is 'transferred' into general borrowings when that qualifying asset is completed (and borrowing costs cease to be capitalised on a specific basis). This situation will often arise in practice.

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Qualifying assets financed by a combination of general and specific borrowings

How does an entity measure borrowing costs eligible for capitalisation where qualifying assets are financed by a combination of specific and general borrowings?
IAS 23 is silent on this situation. In our opinion, it is acceptable to first allocate expenditures to any specific borrowings and then assume that the remaining expenditures are financed with general borrowings. The approach is best illustrated by an example:

Qualifying assets financed with a combination of generally and specifically borrowed funds

An entity has entered into an agreement to construct a qualifying asset for CU 10 million. This agreement was entered into on 1 January 2009, which is the beginning of the entity's reporting period. It is expected that the qualifying asset will be ready for use at the end of the reporting period (31 December 2009).

The entity's financing:
The entity's total borrowings are CU 15 million made up of the following:

- CU 6 million loan with an interest rate of 9%. This loan was taken out entirely to acquire the qualifying asset and is therefore a specific borrowing. This specific borrowing relates to the first payment to the contractor.
- A bank loan of CU 9 million with an interest rate of 11%. The proceeds have been used to finance a combination of working capital, inventories and property, plant and equipment of which some are qualifying assets. The loan has not been used for the purpose of obtaining an individual qualifying asset. The loan is therefore a general borrowing.

It is assumed that there was no fluctuation in interest rates or borrowings through the period.

Expenditures on the asset:

		Additions	Financed by general borrowings	Weighted average	Expenditure for the purpose of general borrowing costs
1 January 2009 (commencement date)		6,000,000	-	n/a	-
1 August 2009	*)	3,000,000	3,000,000	5/12	1,250,000
31 December 2009	*)	1,000,000	1,000,000	0/12	0
		10,000,000	4,000,000		1,250,000

*) These payments have been financed by the entity's general borrowings. This is because the first CU 6 million are financed by specific borrowings.

How does the entity calculate the amount of borrowing cost to be capitalised?
The entity first allocates expenditures to specific borrowings of CU 6 million. The specific borrowing was taken out to finance the payment on 1 January 2009 of CU 6 million and no temporary investment income was received. Interest expense incurred on the loan amounts to CU 540,000.Therefore, the amount of borrowing costs to be capitalised for the specific borrowing is the entire CU 540,000.

Remaining expenditures are allocated to general borrowings. The entity only has one borrowing that is classified as a general borrowing - the CU 9 million loan. The capitalisation rate on general borrowings is 11% (there is only one outstanding general borrowing during the period). The capitalisation rate should be applied to the expenditures on the asset (being the weighted average carrying amount): The expenditures on the asset for the purpose of calculating the general borrowing costs are CU 1,250,000 being the amount financed by general borrowings over a period of 5 months. The amount of borrowing costs eligible for capitalisation for general borrowings amounts to CU 137,500 (11% × CU 1,250,000). Total borrowing costs to be capitalised are:

		Borrowing costs eligible for capitalisation CU
Specific borrowing		540,000
General borrowing		137,500
Total		677,500

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Exchange differences

If an entity has foreign currency borrowings, to what extent are foreign exchange gains and losses eligible for capitalisation?
IAS 23.6(e) states that borrowing costs may include exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs. The standard offers no detailed guidance on how to interpret this. Accordingly, entities should develop their own detailed policy. As with any other accounting policy, the chosen method should be applied consistently and disclosed if significant.

Entities frequently take out loans in a currency other than their functional currency. For these entities it is necessary to determine to what extent exchange differences on these loans can be capitalised.

Is it appropriate to treat all exchange differences on foreign currency borrowings as an adjustment to interest costs?
No. In our view, not all such exchange differences are adjustments to interest costs. Exchange rate movements depend in part on current and expected differences in local currency and foreign currency interest rates (the interest rate differential). However, other factors also contribute to exchange rate changes: a currency will tend to lose value relative to other currencies if a country's level of inflation is higher, if the country's level of output is expected to decline or if a country is troubled by political uncertainty (for example).

Moreover, although exchange gains and losses relate to an entity's foreign currency borrowings, such gains and losses are different in character to interest costs on those borrowings. In particular it is difficult to argue that exchange gains and losses on the principal amount of a loan is an adjustment to interest costs. Exchange gains and losses on the accrued interest portion of the loan's carrying value may more readily be considered an adjustment to interest costs (see below).

What is an appropriate accounting policy for exchange differences?
One acceptable and straightforward approach is not to include any exchange differences as adjustments to interest costs. IAS 23.6(e) states that borrowing costs may include exchange differences to the extent they are regarded as an adjustment to interest costs - it does not therefore require such an adjustment. Applying this approach, interest costs on foreign currency borrowings include only the foreign currency interest expense converted into the entity's functional currency in accordance with IAS 21 *The Effects of Changes in Foreign Currency Exchange Rates*.

Should an entity wish to take account of exchange differences, the challenge is to identify the portion of overall exchange differences that are adjustments to interest costs. A reasonable and practical approach is to treat only exchange differences arising on current period accrued interest as an adjustment to interest costs. This approach considers the adjustment to interest costs as the difference between:

- the amount of interest cost initially recognised in the entity's functional currency using the spot exchange rate at the date of the transaction; and
- the amount the entity has to pay on settlement translated into the entity's functional currency using the spot exchange rate at the date of payment.

Using this approach, exchange differences on the principal amount of the loan are not included in the calculation of borrowing costs to capitalise.

Are any other methods available?
Yes, an entity might develop other models and techniques to determine the exchange differences to include in the calculation of borrowing costs to capitalise. However, in our view any such method should:

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- be consistent with the objective of IAS 23 to include borrowing costs that are directly attributable to a qualifying asset. Borrowing costs are considered to be directly attributable if they would have been avoided had the expenditure on the qualifying asset not been made (IAS 23.10);
- not result in negative interest costs; and
- be consistently applied.

In our view it is not acceptable to:

- include exchange gains in excess of the interest expenses incurred (ie to capitalise a negative amount); or
- capitalise only exchange losses but credit all exchange gains to the income statement.

One alternative approach is to determine a notional borrowing cost based on the interest cost that would have been incurred had the entity borrowed an equivalent amount in its functional currency. In effect, this approach treats a foreign currency loan as a functional currency loan with an embedded foreign currency exchange contract. The IAS 23 calculation is based on the notional functional currency loan. To illustrate this approach, consider an entity that has issued a USD loan (the entity's functional currency is EUR).

Entity with USD loan and a EUR functional currency

On 1 January 20X1 an entity with a functional currency of euros (EUR) takes a US Dollar (USD) loan to finance the construction of a qualifying asset. The amount of the loan is USD 5 million. The loan has a 12 month term and interest is payable at 10% in arrears. Relevant exchange rates are:

- spot rate on 1 January 20X1: USD 1.30 = EUR 1.0
- average rate for 20X1: USD 1.35 = EUR 1.0
- spot rate on 31 December 20X1: USD 1.40 = EUR 1.0

The entity could have borrowed a similar amount in EUR at an interest rate of 8**%**.
For the purpose of this example it is assumed that the average rate for 20X1 is a reasonable approximation of the actual rate prevailing when the interest expense is recognised (see IAS 21.22).

The required calculations are:

USD loan on 1 January 20X1	USD 5,000,000	
USD interest expense at 10%	USD 500,000	
Loan converted into EUR on 1 January 20X1 (at 1.3)	EUR 3,846,154	A
Interest expense converted into EUR at average rate (1.35)	**EUR 370,370**	B
Amount to be repaid on 31 December 20X1 (USD 5,500,000 at 1.4)	EUR 3,928,571	C
Exchange gain on borrowing (A+B-C)	EUR 287,953	D
Interest expense net of exchange gains (B-D)	EUR 82,417	
Interest expense on equivalent EUR loan (3,846,154 at 8%)	**EUR 307,692**	

If the entity elects not to include foreign exchange gains and losses in its borrowing costs, the borrowing costs in relation to this loan would be EUR 370,370.

Alternatively, the entity might include notional borrowing costs based on the interest cost that would have been incurred had the entity borrowed an equivalent amount of euros. This would result in borrowing costs for this loan of EUR 307,692 for IAS 23 purposes. Of the total exchange gain of EUR 287,953, the entity has treated EUR 62,678 as an adjustment to borrowing costs (EUR 370,370 less EUR 307,692). The remaining part of the exchange gain (EUR 225,275) is credited directly to the income statement.

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Derivative gains or losses

Should an entity take into account the effects of hedging in determining borrowing costs?

Hedging instruments (normally derivatives) are frequently used to hedge an entity's exposure to the effects of changes in interest rates. For example, an entity with a floating rate loan may lock in its cash flows by entering into a pay fixed-receive floating interest rate swap (IRS). Other derivatives frequently used are interest rate caps and floors.

Entities frequently hedge **interest rate risk** for borrowings issued to finance a qualifying asset - the hedges may or may not be designated for hedge accounting under IAS 39. Hedge accounting is optional and subject to strict conditions. Where the hedge is not designated the derivative is measured under normal IFRS rules (at fair value through profit or loss).

IAS 23 does not address derivative gains or losses (IAS 23.BC21). Accordingly, IAS 23 does not prohibit capitalisation of the effects of hedging instruments where this is done on a basis consistent with the principles of the standard. Entities will be required to develop an accounting policy that is applied consistently and disclosed if significant.

It should be noted that a derivative such as an IRS is not itself a 'borrowing'. To include the effects of an IRS or other derivative in the determination of the capitalisation rate and total borrowing costs, a link between the IRS and one or more underlying loans must be demonstrated. This will depend on the specific facts and circumstances, and also whether the derivative has been designated for hedge accounting under IAS 39. These considerations are best dealt with in turn (see below).

Can the effects of a derivative not designated for hedge accounting be included in the capitalisation rate or borrowing costs?

Where a derivative is acquired to reduce risk but is not designated as a hedging instrument in accordance with IAS 39, it is often referred to as an 'economic hedge'. In accordance with IAS 39 these derivatives are measured at fair value with gains or losses recognised in profit or loss.

In the absence of a formal hedging designation, it is necessary to consider whether a clear link exists between the IRS and an underlying borrowing. If there is no clear link to an underlying borrowing it is difficult to justify including the effects of the IRS within borrowing costs. Furthermore, the entity will usually not have determined effectiveness of the derivative. Accordingly, our preferred view is that an entity should not include the effects of such a derivative in determining the capitalisation rate or borrowing costs.

However, it should be noted that IAS 23 is not definitive in this area. Entities may be able to demonstrate a sufficiently robust link to an underlying borrowing in some other way and this may justify including certain effects of an IRS in the calculations. In that case, a question arises as to what amount to include in the determination of the capitalisation rate or borrowing costs. In our opinion, it is not acceptable to include all fair value gains or losses. This is because part of the total gain or loss relates to the change in present value of all estimated future settlements. Only the portion of the fair value gain or loss that can be regarded as an adjustment to current period interest cost should be included in the calculations. Moreover, any ineffectiveness in the relationship should be recognised in profit or loss and not capitalised.

Can the effects of a derivative designated for cash flow hedge accounting be included in the capitalisation rate or borrowing costs?

A hedging relationship qualifies for cash-flow hedge accounting only if certain strict conditions are met. Among these requirements is a formal identification of the derivative (hedging instrument) and the loan (hedged item). The hedge must also be highly effective. In our view, meeting the conditions for hedge accounting demonstrates a link between the underlying loan and the derivative. Therefore, in our view the borrowing cost for IAS 23 purposes should take account of the effects of the cash flow hedge on the reported interest expense. To illustrate this, consider the following example of an IRS in a cash-flow hedge:

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Hedge of interest rate risk of borrowings designated as a cash-flow hedge

An entity has issued a loan of CU 1,000. The proceeds are used entirely to finance the acquisition of a qualifying asset (a specific loan). The terms of the loan require interest rate payments based on a floating interest rate. To lock in its cash flows and manage its exposure from changes in interest rates, the entity has entered into a pay fixed-receive floating interest rate swap (IRS). The principal terms of the IRS are the same as for the loan and hence it is expected to be highly effective (IAS 39.AG108).

The entity designates the hedging arrangement as a cash flow hedge under IAS 39. Accordingly, the accounting is as follows:

- The loan is accounted for at amortised cost. Interest expenses are calculated using the effective interest method in IAS 39.
- The IRS is measured at fair value in the statement of financial position. The effective portion of the change in fair value of the IRS is recognised in other comprehensive income. The ineffective portion (if any) is recognised immediately in profit or loss. The amount recognised in equity shall be reclassified from equity to profit or loss in the same period(s) during which the hedged forecast transaction affects profit or loss.

Costs eligible for capitalisation:
The following costs are (or are not) eligible for capitalisation:

- Interest expenses on the loan are eligible for capitalisation. These are calculated using the effective interest method in IAS 39.
- The ineffective portion of gains or losses on the IRS (if any) are not eligible for capitalisation.
- The effective portion of gains or losses on the IRS are eligible for capitalisation during the period they are 'recycled' from the cash flow hedging reserve into profit or loss.
- The periodic net settlements on the IRS are not eligible for capitalisation

Can the effects of a derivative designated for fair value hedge accounting be included in the capitalisation rate or borrowing costs?

Fair value hedges also require formal designation and effectiveness testing. However, the objective and mechanics of fair value hedge accounting differ from cash flow hedge accounting. In a fair value hedge, the hedged item is adjusted (via profit or loss) to reflect changes in the hedged risk. In our view, the entity has an accounting policy choice on whether to include the effects of a fair value hedging instrument when the hedged item is a borrowing.

In the context of hedging a loan, the objective in a fair value hedge is to mitigate changes in the fair value of the loan rather than to manage the interest expense directly. This supports a view that the fair value hedge accounting arrangement is connected with the value of the loan. Under this view the hedging instrument has no effect on borrowing costs for IAS 23 purposes.

However, in many cases the economic reason for using an IRS is to 'convert' a fixed rate loan into floating interest payments. If hedge accounting is applied, this is designated as a fair value hedge. It can therefore be argued that the borrowing costs for IAS 23 purposes should reflect the 'synthetic' floating rate of interest that the entity has achieved. One way of doing this is to reflect the cash flows and interest accruals under the IRS as an adjustment to borrowing costs for the purpose of determining the capitalisation rate, noting that these items do not correspond to the reported fair value changes.

Are hedging relationships taken into account for both general and specific borrowings?

Yes - the principles should be used both for specific and general borrowings.

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Other practical issues

How does an entity determine the amount of borrowing costs that are eligible for capitalisation on a financial liability measured at fair value through profit or loss?
IAS 23 does not preclude capitalisation of borrowing costs in relation to borrowings that are measured at fair value through profit or loss - it would not be appropriate to disqualify interest payments on a borrowing because the borrowing is measured at fair value. However, the interaction between this IAS 39 measurement category and IAS 23 is not entirely clear. This stems from the fact that interest expenses are sometimes presented as part of the fair value gain or loss on the loan and are sometimes presented within finance costs (IFRS 7.B5(e)). Entities should therefore develop an appropriate accounting policy that is consistent with the principles of IAS 23.

Entities are permitted to use the so-called 'fair value option' upon initial recognition of a financial liability, subject to strict conditions. Such borrowings are measured at fair value with gains or losses recognised in profit or loss.

In our view, the most appropriate approach is to base the amount of borrowing costs on the interest cost that would have been incurred if the entity had measured the liability at amortised cost (ie using the effective interest method). Fair value changes attributable to other factors, such as changes in an entity's credit rating and risk free rates, continue to be included in profit or loss in accordance with IAS 39.

Other approaches may be acceptable. However it is not appropriate to include all gains or losses on a financial liability at fair value through profit or loss as part of borrowing costs.

Entities might incur gains or losses arising from refinancing arrangements, for example, early repayment of borrowings or a substantial modification of the terms of borrowings. Is it appropriate to include refinancing gains and losses in the borrowing costs that are eligible for capitalisation?
We believe such gains and losses should not be treated as part of borrowing costs for IAS 23 purposes. IAS 39 is clear that these refinancing gains and losses are included in profit or loss (IAS 39.41). We also believe that any gain or loss on exchanging debt for equity, including expenses recognised on offering holders of a convertible bond an inducement to early convert, should be recognised in profit or loss.

A reporting entity is a 50% venturer in a jointly controlled entity (JCE), for which it uses the proportionate consolidation method in its consolidated financial statements. Should the reporting entity capitalise an appropriate proportion of its general borrowing costs relating to its share of the JCE's qualifying assets?
We believe a portion of the borrowing costs may need to be capitalised in this situation. An entity's decision to apply the proportionate consolidation method means that the venturer's share of the JCE's qualifying assets become group assets (as they are recognised in the statement of financial position). Accordingly, the group's general borrowing costs may have been used for the purpose of obtaining the qualifying assets of the JCE.

How is impairment treated during construction or development?
IAS 36 *Impairment of Assets* will apply for many qualifying assets, however, certain assets are scoped out of IAS 36 (for example inventories).

IAS 23.16 states that when *either* the carrying amount *or* the expected ultimate cost of the qualifying asset exceeds its recoverable amount (or net realisable value for inventories) then the carrying amount is impaired. Importantly, this means that an entity is also required to recognise an impairment loss when the expected ultimate cost of the qualifying asset exceeds its recoverable amount (or net realisable value). Such a loss is recognised immediately.

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How does an entity comply with IFRS 7 disclosures for gains, losses, interest expenses etc. when IAS 23 requires capitalisation of some borrowing costs?

IFRS 7 *Financial Instruments: Disclosures* (IFRS 7) is the standard governing the disclosure requirements for interest expenses and other gains or losses in relation to financial instruments (including borrowings). The requirements in IFRS 7 are connected to the accounting treatment in IAS 39. However, IAS 23 requires capitalisation of borrowing costs that would normally be recognised in profit or loss under IAS 39. A question therefore arises as to how an entity can comply with IFRS 7's disclosure requirements when borrowing costs are capitalised (investment income may also be affected if this is deducted from specific borrowing costs).

IAS 23 is silent in this respect. A practical approach is to include additional information about 'IFRS 7 amounts' that have been capitalised in accordance with IAS 23. This may be possible by presenting an extra line item within the IFRS 7 disclosures. This would satisfy both IFRS 7 requirements and IAS 23's requirement to disclose the amount capitalised during the period (IAS 23.26(a)). The chosen route should give sufficient information in accordance with IAS 1 *Presentation of Financial Statements*.

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D: Period of capitalisation

During which period are borrowing costs required to be capitalised?

The preceding sections consider the amount of borrowing costs to be capitalised and the equally important concept of 'qualifying assets'.

Once it is determined that an entity is required to capitalise borrowing costs, the questions that naturally arise include:

- when does an entity begin capitalisation of borrowing costs?,
- when is capitalisation suspended?, and
- when does an entity cease to capitalise borrowing costs?

We consider these questions in this section.

Commencement of capitalisation

What is meant by "incurs expenditures for the asset"?
The principle in IAS 23.17(a) is that borrowing costs are capitalised only when the entity requires funding for its expenditures on the qualifying asset. IAS 23.18 states that expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities (reduced by progress payments and certain grants). Accordingly, capitalisation of borrowing costs is deferred until this condition is met. In our view, a normal accrual for costs does not satisfy this condition.

The significance of this condition may be limited in practice as payment often occurs without any significant delay after the entity has received goods or services relating to the asset.

Does the entity start capitalising borrowing costs before it borrows funds?
No. Borrowing costs need to be incurred before commencing capitalisation. All of the conditions in IAS 23.17 must be met to begin capitalisation.

What types of activity are "necessary to prepare the asset for its intended use or sale"?
Necessary activities are broader than the physical construction of the asset - they also include technical and administrative work undertaken prior to physical construction. Necessary activities can therefore begin before physical construction starts. Such work may include obtaining permits prior to construction of the asset, but not the holding of an asset without any development taking place (IAS 23.19).

IAS 23.17:

"An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale."

All of the criteria must be met.

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Planning permission is required before starting the construction of a qualifying asset. Management believes permission will be obtained. Does the entity start capitalising borrowing costs before permission has been formally granted?

Seeking permission to begin physical construction is a necessary activity to prepare the asset for its intended use or sale (IAS 23.19). It is therefore appropriate to start capitalising borrowing costs if management expects permission to be given (provided the other conditions in IAS 23.17 are met). Conversely, we believe the entity should discontinue capitalising borrowing costs if approval from the authorities is no longer expected.

An entity holds an asset without any work being undertaken to improve the asset. Is this level of activity acceptable to begin capitalisation?

No. The standard clarifies that the conditions are not met if the only activity is to hold an asset with no production or development activity that changes its condition taking place, eg land acquired for future building purposes but associated development (physical or administrative) has been deferred until future periods (IAS 23.19).

In many situations, a purchaser of an asset is required to make an upfront payment to the contractor or supplier. Does making this payment mean that the commencement date has occurred?

On making an upfront payment the reporting entity has incurred expenditures for the asset. Moreover, in many cases it will be clear that some activities necessary to prepare the asset have either commenced or will do so in the near future. Accordingly the commencement date will usually have been met provided borrowing costs have been incurred.

The situation requires further analysis if there is a significant delay between the payment and the commencement of construction or development activity by the supplier. There is then a question as to whether the 'necessary activity' condition in IAS 23.17(c) is met. In some cases, the act of specifying the asset and placing the order to secure future delivery may amount to necessary activity. In other cases, the upfront payment may be more in the nature of a financing arrangement (particularly if it is refundable). IAS 23 leaves some room for interpretation based on specific facts and circumstances. The following example considers one set of circumstances involving an upfront payment:

Prepayment - purchase of an aircraft

An entity places an order to purchase an aircraft. The entity is required to make a prepayment according to the purchase agreement before actual physical construction of the aircraft starts. The entity takes out a loan specifically to finance the prepayment and incurs borrowing costs on this loan.

When does the entity start capitalising borrowing costs?

Management expects delivery of the asset in 24 months, and management can demonstrate that the asset is a qualifying asset. The next step is to establish the commencement date for capitalisation of borrowing costs.

The entity has taken out a loan to finance the prepayment (so it incurs borrowing costs). Where a prepayment has been made, management is also able to demonstrate that the entity needs funding for the asset (ie the entity incurs expenditures). Accordingly, the first two conditions in IAS 23.17 to establish the commencement date are satisfied.

We also consider that ordering an aircraft and making a prepayment may be an action 'necessary to prepare the asset for its intended use or sale'. If the entity did not place the order and did not make a prepayment, the entity would not be able to secure its position in the supplier's production schedule. The order and prepayment ensures that the entity has a contractual right to receive the aircraft and that the manufacturer will begin construction of the asset (the entity 'claims a place in the queue'). Accordingly, we believe that such an action is 'necessary'.

The arguments are strengthened further if the entity (in addition to placing the order and making the prepayment) has undertaken technical and administrative work to acquire the asset. This might include (for example) specifying the technical details of the aircraft and negotiation of the purchase agreement.

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Suspension of capitalisation

IAS 23.20
"An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset."

Projects are often suspended for extended periods but the entity still incurs borrowing costs during such periods. Are these borrowing costs still capitalised?
Not when active development of a qualifying asset is suspended during extended periods (IAS 23.20). This is consistent with the guidance in IAS 23.19, which clarifies that capitalisation is not permitted when no production or development that changes the asset's condition is taking place. The standard also states that borrowing costs that are incurred while holding partially completed assets do not qualify for capitalisation (IAS 23.21).

Physical construction has been suspended for an extended period while engineers improve the technical specifications of the asset. Are borrowing costs still capitalised during this period of time?
Yes, if the continuing engineering work is substantial. An entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work (IAS 23.21). IAS 23 does not define 'substantial work' so judgement may be required in specific circumstances. However, it is clear that ongoing engineering work may well be substantial.

The same rules apply for work that is administrative (not technical).

Management has been forced to delay the project for external reasons. Should borrowing costs still be capitalised?
It depends. The standard states that an entity does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale (IAS 23.21). For example, where high water levels delay construction of a bridge (if such high water levels are common during the construction period in the geographical region involved) then capitalisation of borrowing costs should not be suspended (IAS 23.21). This is an example of a necessary suspension that is part of the construction process and, accordingly, capitalisation continues.

It is not always clear whether a delay is 'necessary' and judgement may therefore be required. The following examples discuss some possible scenarios:

Delay in the construction process – a necessary part of the process?

Workers go on strike
In our opinion this does not represent a necessary part of getting an asset ready for its intended use or sale. Accordingly, we believe that the entity should suspend capitalising borrowing costs if the delay is for an extended period of time.

Fire damage
A delay caused by an accident such as a fire is not a necessary part of getting the asset ready for its intended use or sale. Accordingly, we believe that the entity should suspend capitalising borrowing costs if the delay is for an extended period of time.

Factory closed down during holiday season
Many companies apply a policy of closing down a production facility during a holiday season. This may apply over a festive season or because of a general industrial holiday. Where such a policy is part of the normal course of business, we believe it is a necessary part of getting an asset ready for its intended use or sale. Accordingly, we believe that the entity should continue capitalising borrowing costs.

The production process is slow
A slow production process may occur for many reasons. In our view, this is not a delay in the construction process. Accordingly, we believe that the entity shall continue capitalising borrowing costs.

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Cessation of capitalisation

IAS 23.22
"An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete."

Physical construction of a building is complete but some administrative work is outstanding. Should the entity cease to capitalise borrowing costs?
This depends on the nature of the ongoing administrative work. When physical construction is complete, IAS 23.23 states that an asset is normally ready for its intended use or sale even though routine administrative work might continue (IAS 23.23). Judgement needs to be applied as to whether the ongoing administrative work is routine or significant.

To be significant in this context, the ongoing administrative work must be part of the process of getting the asset ready for its intended use or sale. To illustrate, consider a newly completed investment property for which the entity needs to find a tenant. In this situation the asset is ready for its intended use or sale even though it is not yet generating a return. It is not therefore appropriate to continue capitalising borrowing costs.

The application is further illustrated below:

Physical construction complete

Investment property for sale
On 1 February 2009 physical construction of an investment property was completed. All the necessary administrative works were completed on 22 February 2009. On 1 April 2009 the entity had not succeeded in finding a buyer. The entity ceases to capitalise borrowing costs from the day when substantially all the necessary activities to make the asset ready for sale were complete. This would be either 1 February 2009 or 22 February 2009 depending on the significance of the administrative work undertaken between those dates.

Building complete - fire safety approval is outstanding
An entity has completed the physical construction of a building but is not permitted to use it until fire approval is obtained. Often it is a formality to obtain the necessary approval for fire safety. In such cases it is appropriate to cease capitalisation on physical completion. If the building fails the inspection, and substantial additional work is then required, it may be necessary to resume capitalisation of borrowing costs.

A property developer has finished construction of a building apart from minor outstanding works. Are all the substantial activities completed in order to cease capitalisation of borrowing costs?
Yes. If minor modifications (such as the decoration of a property to the purchaser's or user's specification) are the only remaining activities, this indicates that substantially all the activities are complete (IAS 23.23).

If a qualifying asset is completed in parts, when does an entity cease to capitalise borrowing costs?
If each part of the qualifying asset is capable of being used while construction continues on other parts, an entity should cease to capitalise borrowing costs on the finished part when an entity substantially completes the activities on that part (IAS 23.24).

An entity does not cease to capitalise borrowing costs where a completed part cannot be used without completion of another part of the asset.

To illustrate the principles consider the following examples:

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Cessation of capitalisation - assets completed in part

Completion of a business park
A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts (IAS 23.25). To illustrate this consider a business park with two buildings, one of which is finished 8 months before completion of the second. An entity ceases to capitalise borrowing costs on the first building when it has completed substantially all the activities necessary to prepare this building for its intended use or sale. Borrowing costs continue to be capitalised on the second building.

Shopping centre
An entity constructs a shopping centre and an adjacent multi-storey car park.

Major construction work on the shopping centre is completed first but the fit-out work (which is essential for the intended use) continues. At this stage the building is not ready for use and the entity continues to capitalise borrowing costs. When the fit-out is substantially complete the entity ceases to capitalise borrowing costs on the shopping centre.

The multi-storey car park is capable of being used independently. If construction of the car park continues after work on the shopping centre is complete, borrowing costs continue to be capitalised on the car park. The treatment of the shopping centre is not affected by the later completion of the car park.

Industrial plant
An entity constructs a steel mill, involving several processes which are carried out in sequence at different parts of the plant within the same site. The industrial plant as a whole needs to be completed before any part can be used. Accordingly, the entity does not cease to capitalise borrowing costs when one part (which cannot be used individually) is finished (IAS 23.25).

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E: Group situations

How are borrowing costs treated in consolidated and separate financial statements?

In this section we consider some common questions in relation to capitalisation of borrowing costs in group situations, in particular:

- the treatment of external and intra-group borrowing costs in the separate financial statements of the parent or individual financial statements of a subsidiary,
- the treatment of external and intra-group borrowing costs in consolidated financial statements,
- some problems arising in consolidated financial statements when qualifying assets are constructed by one group entity and borrowing costs are incurred by another.

Separate and individual financial statements

Where an entity presents separate or individual financial statements can the eligible pool of borrowing costs also include intra-group borrowing costs?
Yes. In determining the amount of borrowing costs to be capitalised in the separate financial statements of a parent or individual financial statements of a subsidiary, the relevant borrowing costs can include costs in relation to both external and intra-group borrowings.

Identifying relevant borrowing costs and qualifying assets in individual or separate financial statements

A group consists of the parent P and two subsidiaries, A and B. A is engaged in the construction of a business park with funding being provided by B which charges intra-group interest at a market rate. The parent P and subsidiary B are cash-rich, and the group as a whole has no external borrowings.

Can the finance costs on the borrowings be capitalised in the individual financial statements of A or B?

In this situation A must capitalise interest, as it has both a qualifying asset (the construction of the business park) and borrowing costs (the intra-group interest charged by B). At individual company level, it is irrelevant that A's borrowings are intra-group.

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Other group entities may have provided financing for a group entity's construction of a qualifying asset. Such intra-group borrowings are often made on an interest-free basis or at a rate of interest that is less than would be charged in an arm's length transaction. How is the amount of borrowing costs determined?

As noted in the preceding answer the relevant borrowing costs can include intra-group borrowings. The amount of intra-group borrowing costs is determined by applying IAS 39's effective interest rate method (IAS 23.6(a)). This may result in a different level of borrowing costs being capitalised than the interest rate stated in the loan agreement.

To illustrate the application, consider the following two examples:

Intra-group borrowings

Example 1: Interest-free loan repayable on demand

A group consists of the parent P and a number of subsidiaries, including subsidiary A. Subsidiary A is engaged in the construction of a business park but is not cash rich. P therefore borrows externally and lends money to subsidiary A. The intra-group loan is on an interest-free basis and is repayable on demand.

Can finance costs be capitalised in the separate financial statements of A or P?

In this situation, there is no intra-group interest charge in the individual financial statements of Subsidiary A (none is imputed because IAS 39 requires on-demand borrowings to be reported at the amount repayable on demand - IAS 39.49). Accordingly, no interest should be capitalised in the individual financial statements of subsidiary A because the subsidiary has incurred no borrowing costs.

Parent P has incurred external borrowing costs but, at entity-only level, has no qualifying asset. Therefore, the borrowing costs on the parent's external loan cannot be capitalised.

Example 2: Interest-free fixed term loan not repayable on demand

The circumstances are as in Example 1, however, the loan made by the parent P to its subsidiary A is not repayable on demand and is for a fixed term. It is interest-free.

Can finance costs be capitalised in the separate financial statements of A or P?

If a loan is provided at a rate of interest which is less than the market rate and the loan is not repayable on demand, then the fair value of the loan on initial recognition will differ from the proceeds received. The effective interest method is based on the fair value of the loan. An interest charge will therefore arise.

IAS 23.6(a) states that borrowing costs may include interest expense calculated using the effective interest rate method as described in IAS 39. Accordingly, subsidiary A is required to include the effects of the interest charge in its individual financial statements. This is because subsidiary A has both a qualifying asset and borrowing costs.

Parent P has incurred external borrowing costs but, at entity-only level, has no qualifying asset. Therefore, the borrowing costs on the parent's external loan cannot be capitalised.

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Consolidated financial statements

Is capitalisation of borrowing costs in consolidated financial statements applied from the perspective of the group?
Yes. At consolidated level, IAS 23 is applied as though the parent and its subsidiaries are a single economic entity. The relevant borrowing costs are those incurred by the group that would have been avoided if the expenditure on the qualifying asset had not been made (IAS 23.10).

Consequently, interest charged by one group entity to another cannot be capitalised in the consolidated financial statements. Intra-group borrowing costs are eliminated on consolidation.

At consolidated level, IAS 23 is applied as though the parent and its subsidiaries are a single economic entity.

- Borrowing costs in consolidated financial statements include only costs incurred on borrowings external to the group - intra-group borrowing costs are eliminated on consolidation.
- The definition of a qualifying asset may be met at consolidated level but not in separate or individual financial statements of group entities.

Is an investment in a subsidiary a qualifying asset in a parent's consolidated financial statements?
An investment in a subsidiary is not itself a qualifying asset. Accordingly, no interest will be capitalised on such an investment in the parent's separate financial statements. However, on consolidation the parent eliminates the investment and recognises the subsidiary's underlying assets and liabilities directly (including any qualifying assets). Therefore the subsidiary's qualifying assets are (in effect) regarded as group assets on consolidation.

Construction of an asset takes place in one group company but borrowing costs are incurred in another. Are borrowing costs capitalised in the consolidated financial statements?
As noted above, a qualifying asset of a subsidiary is (in effect) regarded as a qualifying asset of the group. Capitalisation of borrowing costs in consolidated financial statements may therefore be required even if the qualifying asset is being constructed or developed by a group entity that has not incurred eligible borrowing costs.

For example, a parent entity might borrow funds externally to provide finance to the construction of a qualifying asset in another group entity. From the perspective of the group, the external borrowing costs incurred by the parent are capitalised to the extent they are directly attributable to the acquisition, construction or production of a qualifying asset. Intra-group borrowing costs are eliminated on consolidation and are not capitalised.

To illustrate, consider the following example:

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Construction in one subsidiary, borrowing costs incurred in another group entity

A group consists of the parent P and a number of subsidiaries, including subsidiary A. Subsidiary A is engaged in the construction of a business park.

The group is not cash rich. P therefore borrows funds externally and lends money to other group entities including subsidiary A. The loan made by the parent to its subsidiary has a market interest rate and is for a fixed term (not repayable on demand).

Can finance costs be capitalised in the consolidated financial statements of P?

At consolidated financial statement level, the group is viewed as if it were a single economic entity, meaning that there is both a qualifying asset (in subsidiary A) and borrowing costs on the external bank borrowings (borrowing in the parent). Interest is capitalised to the extent that borrowing costs incurred are directly attributed to the construction of the qualifying asset, ie the amount that would have been avoided if the expenditure on the qualifying asset had not been made.

Only the borrowing costs incurred on the external loan is available for capitalisation - intra-group interest charged by the parent P to subsidiary A is eliminated on consolidation.

How is the capitalisation rate determined in consolidated financial statements?
IAS 23.15 considers at which level of the group the capitalisation rate is computed. An entity-view requires that the capitalisation rate should be based on the consolidated level weighted average of borrowing costs.

However, IAS 23.15 allows some flexibility and states that in some circumstances it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings. The more appropriate approach will depend on the funding arrangements within the group.

After applying the capitalisation rate to expenditures on qualifying assets, management must be able to demonstrate that the amount to be capitalised does not exceed the amount of external borrowing costs incurred at the consolidated level (IAS 23.14).

How is IAS 23 applied if an entity acquires a new subsidiary (which is also a business) that has a qualifying asset under construction at the date of acquisition?
As noted above, the subsidiary's qualifying asset is (in effect) regarded as a group asset on consolidation. Accordingly, interest will or may need to be capitalised in the post-combination consolidated financial statements. The interaction with the requirements of IFRS 3 *Business Combinations* affects the determination of the relevant expenditures for the qualifying asset. The acquisition date fair value is the opening amount for the purpose of working out an average carrying value. The pre-combination date costs incurred by the subsidiary (including any interest capitalised) are no longer directly relevant. If the acquisition was partly or wholly funded by debt, the borrowing costs incurred are likely to form part of the pool of general borrowing costs for IAS 23 purposes.

The following example provides an illustration:

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Acquisition of a business

An entity (acquirer) acquires a new subsidiary (acquiree), incurring borrowings to fund part of the consideration transferred. The acquiree is constructing a property, and has existing borrowings which are being used to part finance the cost of the project.

The under-construction property will be initially recognised on acquisition in the consolidated financial statements at its fair value. This amount is treated as the opening 'cost' of the property for the purpose of capitalising borrowing costs. In the post-combination consolidated financial statements the property is regarded as a qualifying asset financed by a combination of general and specific borrowings (see section C). Accordingly, it is acceptable that the specific borrowing costs (incurred at subsidiary level) are capitalised first. The borrowing costs incurred by the parent form part of the pool of general borrowings. If the fair value of the acquired property (which is in effect the cost to the group) exceeds the amount of its cost financed by specific borrowings of the acquiree, it is appropriate to capitalise a portion of general borrowing costs in relation to this excess.

Illustrating this point numerically, Company A acquires Company B at 1 January 20X1, paying CU 50,000, which is financed by cash of CU 20,000 and borrowings of CU 30,000. Costs incurred on these borrowings in the period between the acquisition date and the end of the reporting period were CU 2,000. It is assumed the parent entity does not have other borrowings.

Company B's net assets consist of the following:

	Book cost (CU)	Fair value on acquisition (CU)
Property under construction *	40,000	50,000
Other assets	20,000	20,000
Borrowings related to property	-20,000	-20,000
Net assets	40,000	50,000

* Note that the example assumes that all of the borrowing costs incurred relate to the period during which the property is under construction. For simplicity, it is also assumed that the value of the property does not change during that period, although in practice the value would change as construction progresses which would have a knock-on effect on the determination of the amount of directly attributable borrowing costs.

In the period between the acquisition date and the end of the reporting period, Company B incurred borrowing costs of CU 1,000 in relation to a loan that is specific to the property under construction.

Post-combination accounting for borrowing costs
The borrowing costs to be capitalised first are the actual borrowing costs of CU 1,000 incurred on the specific borrowing of CU 20,000 taken out directly by company B in relation to the construction of the property.

For the remaining expenditures of CU 30,000 (fair value of property CU 50,000 less specific borrowings of CU 20,000) we believe it is acceptable to apply a capitalisation rate. As noted, the parent entity only has the loan issued in connection with financing the acquisition at 1 January 20X1. Accordingly, its capitalisation rate is 6.67% (CU 2,000 / CU 30,000). The entity then applies the capitalisation rate to the remaining expenditures allocated to general borrowings, being CU 30,000. Accordingly, it capitalises CU 2,000 of the general borrowing costs.

In total then, CU 3,000 of interest costs are capitalised - CU 1,000 of interest costs incurred directly by the subsidiary and CU 2,000 of the parent's general borrowing costs.

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F: Effective date and transition

Existing preparers with a previous policy of expensing borrowing costs

Are entities required to apply IAS 23 retrospectively to all qualifying assets?

The revised version of IAS 23 applies for annual periods beginning on or after 1 January 2009.

The transitional rules in IAS 23 include significant reliefs for existing preparers that have been following the accounting policy of immediately recognising borrowing costs as an expense. If applied retrospectively, those entities would be required to capitalise borrowing costs for assets that may have completed their construction process many years ago.

In this section we examine the transitional reliefs for existing preparers with a previous policy of expensing borrowing costs.

On first-time application, is an entity required to capitalise borrowing costs incurred subsequent to the effective date on in-progress qualifying assets for which acquisition, construction or production commenced before the effective date?
No. Retrospective restatement is not required in respect of projects whose commencement date is before IAS 23's effective date. However, an entity that applied the previous benchmark treatment and recognised all borrowing costs as an expense has a choice on initial application of the revised standard:

- It can continue to expense borrowing costs on those qualifying assets in the course of construction or production at the effective date and only begin to capitalise borrowing costs in respect of those qualifying assets whose commencement date is after the effective date (IAS 23.27),
- Alternatively, it can designate an earlier date as the effective date. This earlier date can be part way through an accounting period, for example the date that a particular construction project is started. It will then capitalise borrowing costs in respect of qualifying assets whose commencement date for capitalisation is on or after this designated date (IAS 23.28).

To illustrate consider the following example:

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Existing preparer with a previous policy of expensing borrowing costs

An entity is engaged in the construction of two qualifying assets. Both projects are financed by specific bank borrowings. The commencement date for capitalisation for Project One is 1 December 2008 and for Project Two is 1 July 2009. The entity prepares its financial statements to 31 March each year. Its accounting policy is to recognise all borrowing costs as an expense in the period in which they are incurred.

How should the entity apply the change in accounting policy for borrowing costs on initial application of the revised standard?

The entity will apply the revised standard in preparing its financial statements for the year ended 31 March 2010. The relevant effective date is therefore 1 April 2009.

The entity will not restate the comparatives in respect of those borrowing costs incurred prior to 1 April 2009 on Project One. Borrowing costs incurred after 1 April 2009 in relation to Project One will also continue to be expensed.

Borrowing costs incurred on Project Two will be capitalised from 1 July 2009 until the activities necessary to prepare the asset for its intended use or sale are complete.

The entity may choose to designate an earlier date for adoption of the revised standard, for example 1 December 2008. If it does so then borrowing costs incurred in relation to Project One for the period 1 December 2008 to 31 March 2009 will be capitalised in the March 2009 financial statements.

First-time adopters

How is IAS 23 applied by a first-time adopter?

First-time adopters are generally required to apply IFRS retrospectively. To apply IAS 23 retrospectively would not only impose a significant burden for first-time adopters in relation to completed qualifying assets, but would also be inconsistent with the requirements for existing preparers.

IFRS 1 (the standard that governs the rules for first-time adopters) therefore allows a first-time adopter an optional exemption (IFRS 1.Appendix D23). This broadly gives the same reliefs for first-time adopters as for existing preparers. This section describes the options available for a first-time adopter.

IFRS 1 Appendix D.23

"A first-time adopter may apply the transitional provisions set out in paragraphs 27 and 28 of IAS 23, as revised in 2007. In those paragraphs references to the effective date shall be interpreted as 1 July 2009 or the date of transition to IFRSs, whichever is later."

Previous version of IFRS 1:

IFRS 1.D23 is mandatory for periods beginning on or after 1 July 2009.

For accounting periods beginning on or after 1 January 2009 a first-time adopter may apply a similar exemption where the effective date is 1 January 2009 (IFRS 1.25I).

A first-time adopter does not choose the exemption in IFRS 1. How does the first-time adopter treat borrowing costs in its opening statement of financial position?

If a first-time adopter's first IFRS reporting period begins on 1 January 2009 or later and it does not take up the IFRS 1.D23 option, it will be required to apply IAS 23 in its opening IFRS statement of financial position as though it had always done so. This will require capitalisation of borrowing costs both for in-progress and completed qualifying assets held at the date of transition to IFRS.

There is no specific exemption in IFRS 1 permitting a previous GAAP method of capitalising borrowing costs. Therefore, if the first-time adopter had a previous GAAP policy of capitalising borrowing costs, the first-time adopter may be required to adjust previously capitalised amounts if they are inconsistent with IAS 23.

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A first-time adopter has a previous GAAP policy of expensing borrowing costs. When should the first-time adopter start capitalisation of borrowing costs where the entity chooses to apply the exemption in IFRS 1?

In applying the exemption on first adopting IFRS an entity may:

- capitalise borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009 or the date of transition to IFRS, whichever is the later, or
- designate an earlier date as the effective date, which may be part way through an accounting period.

Whichever date is determined as the effective date, the entity capitalises borrowing costs prospectively relating to all new qualifying assets for which the commencement date for capitalisation is on or after that date. The first-time adopter continues expensing borrowing costs for all in-progress qualifying assets for which the commencement date is before the effective date. To illustrate, consider the following example:

First-time adopter with a previous GAAP policy of expensing borrowing costs

A first-time adopter prepares its first IFRS financial statements at 31 December 2009. Accordingly, the first-time adopter should apply IAS 23 as this is effective in annual periods beginning on or after 1 January 2009. The first-time adopter has chosen to apply the exemption in IFRS 1.

Option 1: Do not designate an earlier date
The first-time adopter's relevant effective date for application of IAS 23 is 1 January 2009. This is later than the date of transition to IFRS (1 January 2008) and is therefore the appropriate date to consider.

All borrowing costs on in-progress qualifying assets for which the commencement date is before 1 January 2009 will continue to be expensed under IFRS, which includes those on qualifying assets for which the commencement date is between the transition date and 1 January 2009. The first-time adopter shall capitalise borrowing costs for all qualifying assets for which the commencement date is on or after 1 January 2009.

Option 2: Designate an earlier date
The first-time adopter has decided to apply IAS 23 from 1 September 2007.

For all qualifying assets whose construction commenced before 1 September 2007, borrowing costs will continue to be expensed. The carrying amounts in the opening statement of financial position will be adjusted to include capitalisation of borrowing costs for qualifying assets for which the commencement date is on or after 1 September 2007. Retained earnings at the date of transition are adjusted by the borrowing costs previously expensed. Profit and loss for the comparative period is adjusted by the borrowing costs previously expensed in that period.

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A first-time adopter has a previous GAAP policy of capitalising borrowing costs which is inconsistent with the method specified by IAS 23. What are the options for the first-time adopter?

There is no specific exemption in IFRS 1 permitting a previous GAAP method of capitalising borrowing costs. In preparing its first IFRS financial statements, the first-time adopter may choose to:

- apply IAS 23 fully retrospectively from its date of transition. This may require adjustment to the amount of borrowing costs capitalised under previous GAAP; or
- take the exemption in IFRS 1.D23. The entity then capitalises borrowing costs prospectively only for new qualifying assets whose commencement date for capitalisation is on or after the later of 1 January 2009 or the transition date to IFRS (the 'first commencement date'). For qualifying assets held at the transition date, amounts capitalised under previous GAAP would be removed and adjusted directly against retained earnings at the date of transition to IFRS, with consequent changes to depreciation, etc (IFRS 1.11). Borrowing costs incurred between the transition date and first commencement date would be recognised in profit or loss; or
- take the exemption in IFRS 1.D23 and also select an earlier effective date, which may be part way through an accounting period (for example the date on which a specific construction project commenced). It would then capitalise borrowing costs prospectively only for new qualifying assets whose commencement date for capitalisation is on or after the specified date. If the specified date is earlier than the date of transition:
  - the transition date carrying values will include borrowing costs for the relevant new qualifying assets, determined in accordance with IAS 23. For other qualifying assets held at the transition date, amounts capitalised under previous GAAP would be removed and adjusted directly in retained earnings;
  - borrowing costs incurred after the transition date would be accounted for in accordance with IAS 23.

Consider the following example:

First-time adopter of IFRS with a previous GAAP policy of capitalising borrowing costs

A first-time adopter, a property developer, is engaged in the construction or development of the following qualifying assets: residential properties held for resale classified as inventory; office premises classified as property, plant and equipment; commercial property classified as an investment property; and computer software classified as an intangible asset. Each project is funded by bank borrowings.

Construction of the office premises was completed on 30 June 2002 when the property was available for use. Construction of the investment property commenced on 1 September 2007 and was completed on 15 April 2008 when the property was available for rental. Both properties were still held at 31 December 2009. The development costs of the computer software met the recognition criteria in IAS 38 *Intangible Assets* from 1 August 2008. The project is incomplete at 31 December 2009.

The first-time adopter will prepare its first IFRS financial statements for the year ended 31 December 2009. The transition date is therefore 1 January 2008. The first-time adopter will use the cost model in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property.* Its previous GAAP policy is to capitalise borrowing costs in relation to qualifying assets. However, it uses a method of capitalisation that does not comply with IAS 23.

How should the first-time adopter apply the change in accounting policy for borrowing costs on first-time adoption of IFRS?

The first-time adopter's first IFRS reporting period commences on 1 January 2009. It must therefore comply with IAS 23 in preparing its first IFRS financial statements.

(continues)

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First-time adopter of IFRS with a previous GAAP policy of capitalising borrowing costs (continued)

Option 1 – full retrospective application
The amount of borrowing costs capitalised under previous GAAP will be adjusted to that required by IAS 23 for all of the qualifying assets held at the transition date (both completed and in progress assets), unless some or all of those assets are measured using fair value as deemed cost (see Example below). After the date of transition borrowing costs will continue to be capitalised as required by IAS 23.

Option 2 – apply the IFRS 1.D23 election
The first-time adopter's relevant effective date for application of IAS 23 is 1 January 2009. This is later than the date of transition to IFRS (1 January 2008) and is therefore the appropriate date to consider.

Borrowing costs incurred in relation to the construction of the office premises and commercial property and development of the computer software will be expensed as construction or development of these assets commenced prior to 1 January 2009. The carrying amounts will therefore be adjusted to exclude borrowing costs capitalised under previous GAAP. Retained earnings at the date of transition to IFRS are adjusted by the borrowing costs previously capitalised up to that date. The profit and loss for the comparative period is adjusted by the borrowing costs previously capitalised in that period.

Where construction of the residential property commenced before 1 January 2009, borrowing costs will be expensed. The carrying amounts will therefore be adjusted to exclude borrowing costs capitalised under previous GAAP. Retained earnings at the date of transition to IFRS are adjusted by the borrowing costs previously capitalised up to that date. The profit and loss for the comparative period is adjusted by the borrowing costs previously capitalised in that period. The amount of borrowing costs capitalised under previous GAAP on those properties where construction commenced after 1 January 2009 will be adjusted to that required by IAS 23.

Option 3 - apply the IFRS 1.D23 election and select an earlier date
The first-time adopter may elect to apply IAS 23 from an earlier date, for example 1 September 2007 (when construction of the commercial property commenced).

All borrowing costs capitalised under previous GAAP in relation to the office premises will be expensed as construction of this asset commenced prior to 1 September 2007. Retained earnings at the date of transition to IFRS are adjusted by the borrowing costs previously capitalised up to that date. The profit and loss for the comparative period is adjusted by the borrowing costs previously capitalised in that period.

The amount of borrowings capitalised under previous GAAP in relation to the commercial property and the computer software will be adjusted to that required by IAS 23 as the construction or development of these assets commenced on or after 1 September 2007. The adjustment will be to retained earnings at the date of transition to IFRS to the extent it relates to borrowing costs capitalised in the period to 1 January 2008. The adjustment will be to the profit or loss for the comparative period to the extent it relates to borrowings costs capitalised in that period.

For the residential properties whose construction commenced before 1 September 2007, borrowing costs will be expensed. The carrying amounts will therefore be adjusted to exclude borrowing costs capitalised under previous GAAP. Retained earnings at the date of transition to IFRS are adjusted by the borrowing costs previously capitalised up to that date. The profit and loss for the comparative period is adjusted by the borrowing costs previously capitalised in that period. The amount of borrowing costs capitalised under previous GAAP on those properties where construction commenced after 1 September 2007 will be adjusted to that required by IAS 23.

What if a first-time adopter elects to use deemed cost for the qualifying asset?
Independently of its choices under IFRS 1.D23 and its previous GAAP policy for borrowing costs, the entity may apply the exemptions in IFRS 1.D5 - D8 (previously IFRS 1.16-19). This allows the entity to measure items of property, plant and equipment or investment properties (provided the entity has elected to use the cost model in IAS 40 *Investment Property*) at fair value or a previous GAAP revaluation. These amounts are treated as the 'deemed cost' of the asset(s) at the transition date. If the entity decides to do this, it effectively ignores the treatment of borrowing costs incurred on the applicable assets up to the transition date (or the date of the measurement that established the deemed cost if earlier). After the transition date, borrowing costs are accounted for in accordance with IAS 23, subject to the entity's elections under IFRS 1.D23. The IFRS 1.D5 - D8 exemptions are not however available for some qualifying assets such as inventories, development properties, and intangible assets that do not meet the IAS 38 *Intangible Assets* criteria for revaluation (eg expenditure on internally developed software).

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Fair value as deemed cost at date of transition

The facts are as in the previous example above. However, the first-time adopter has elected to measure the office premises and commercial property at fair value at 1 January 2008, being its date of transition to IFRS, and use fair value as their deemed cost as at that date.

How will this affect the application of the change in accounting policy for borrowing costs on first time adoption of IFRS?

Option 1 – full retrospective application
Borrowings costs incurred in relation to the office premises and commercial property before 1 January 2008 and capitalised under previous GAAP are not separately included in the transition date carrying amounts because those assets are stated at their fair values. The office premises were completed prior to the transition date therefore no further borrowing costs will be capitalised. Borrowing costs incurred in the period 1 January 2008 to 15 April 2008 in relation to the commercial property will be capitalised in accordance with the revised standard. The profit and loss for the comparative period is adjusted for the difference between the amount of borrowing costs capitalised in that period under previous GAAP and the amount required by IAS 23.

Option 2 – apply the IFRS 1.D23 election
The first-time adopter's transition date is 1 January 2008. The relevant effective date for application of IAS 23 is therefore 1 January 2009.

Borrowing costs incurred in relation to the office premises and commercial property before 1 January 2008 and capitalised under previous GAAP are not separately included in the transition date carrying amounts because those assets are stated at their fair values. The office premises were completed prior to the transition date therefore no further borrowing costs will be capitalised. Borrowing costs incurred in the period 1 January 2008 to 15 April 2008 in relation to the commercial property will be expensed as construction of this property commenced before 1 January 2009. The profit and loss for the comparative period is adjusted by the borrowing costs previously capitalised in that period.

Option 3 - apply the transitional provisions from an earlier specified date
The first-time adopter may elect to apply IAS 23 from an earlier date, for example 1 September 2007 when construction of the commercial property commenced.

Borrowing costs incurred in relation to the office premises and commercial property before 1 January 2008 and capitalised under previous GAAP are not separately included in the transition date carrying amounts because those assets are stated at their fair values. The office premises were completed prior to the transition date therefore no further borrowing costs will be capitalised. Borrowing costs incurred in the period 1 January 2008 to 15 April 2008 in relation to the commercial property will be capitalised in accordance with the revised standard as the construction of this property commenced on or after the specified date of 1 September 2007. The profit and loss for the comparative period is adjusted for the difference between the amount of borrowing costs capitalised in that period under previous GAAP and the amount required by IAS 23.

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