International Public Sector Accounting Standards Board®

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Meeting:	International Public Sector Accounting Standards Board	**Agenda Item 4**	For:
Meeting Location:	Virtual Meeting		☒ Approval
Meeting Date:	September 14–18 and 22, 2020		☐ Discussion
			☐ Information

ED 74, AMENDMENTS TO IPSAS 5, *BORROWING COSTS*

Project summary	To issue amendments to IPSAS 5, *Borrowing Costs*, to clarify the application of “qualifying asset” and “directly attributable” based on the responses received to CP, *Measurement*.	
Board Sponsor	• David Watkins, IPSASB Technical Advisor	
Meeting objectives	***Topic***	***Agenda Item***
Project management	ED 74 Amendments to IPSAS 5, *Borrowing Costs*: Project Roadmap	4.1.1
	Instructions up to Previous Meeting	4.1.2
	Decisions up to Previous Meeting	4.1.3
Decisions required at this meeting	Development: ED 74 Amendments to IPSAS 5, *Borrowing Costs*	4.2.1
	Approval: ED 74 Amendments to IPSAS 5, *Borrowing Costs*	4.2.2
Other supporting items	ED 74 Amendments to IPSAS 5, *Borrowing Costs*	4.3.1

Prepared by: Dave Warren (August 2020)

ED 74, AMENDMENTS TO IPSAS 5, BORROWING COSTS: PROJECT ROADMAP

Meeting	Completed Actions or Discussions / Planned Actions or Discussions:
March 2019	1. Approve Consultation Paper and Illustrative Exposure Draft
December 2019	1. Preliminary Review of Responses to Consultation Paper
March 2020	1. Review of Responses to Consultation Paper 2. Discussion of Issues
June 2020	1. Review Exposure Draft
September 2020	1. Approve Exposure Draft

INSTRUCTIONS UP TO PREVIOUS MEETING

Meeting	Instruction	Actioned
June 2020	1. No decisions. ED 74 was provided for informational purposes only.	1. Not applicable
March 2020	1. Distinguish between borrowing costs and transaction costs in the BCs of IPSAS 5	1. See Agenda Item 7.3.6 (paragraph BC 8 – BC 11)
	2. Develop IEs and/or IGs to replace AGs proposed clarifying “qualifying asset” and “directly attributable”.	2. See Agenda Item 7.3.6 (paragraph BC 8 – BC 11)
December 2019	1. Provide recommendations on how to take accounting for borrowing costs forward, based largely on the retention of the current approach (including draft text).	1. Retain Accounting Policy Choice to expense / capitalize borrowing costs. BCs of IPSAS 5 are updated to reflect decision (See Agenda Item 8.2.3)

DECISIONS UP TO PREVIOUS MEETING

Meeting	Decision	BC Reference
June 2020	1. No decisions. ED 74 was provided for informational purposes only.	1. Not applicable
March 2020	1. No decisions made (detailed review of responses)	1. Not applicable
December 2019	1. No decisions made (preliminary review of responses)	1. Not applicable
March 2019	1. All decisions made up until March 2019 were reflected in the Consultation Paper on Measurement	1. All decisions made up until March 2019 were reflected in the Consultation Paper on Measurement

Agenda Item 4.2.1

Development: ED 74 Amendments to IPSAS 5, Borrowing Costs

Purpose

1. To summarize for the Board the process followed in developing [draft] (ED 74), Amendments to IPSAS 5, *Borrowing Costs*.

Background

2. One of the preliminary views included in CP, *Measurement,* was to remove the accounting policy choice in IPSAS 5 to either expense or capitalize borrowing costs, and require all borrowing costs be expensed.

3. Respondents were divided almost evenly between agreeing and disagreeing with the preliminary view. Given the divide, in December 2019, the IPSASB instructed Staff to propose a practical way forward.

4. In March 2020, Staff recommended the accounting policy choice be retained and supplemented with Application Guidance to clarify the application of “qualifying asset” and “directly attributable” expenditures.

   (a) The IPSASB agreed with the recommendation but instructed Staff to repurpose the AGs to Illustrative Examples and Implementation Guidance, as this is more relevant to constituents in these circumstances;

   (b) The IPSASB also agreed the borrowing costs PV could be addressed independently from the Measurement Project. This is because:

      (i) Decisions related to borrowing costs have little impact on the broader IPSAS, *Measurement*; and

      (ii) Closing this issue will enable the IPSASB to focus on broader measurement issues at upcoming meetings.

5. The IPSASB was provided with a second version of ED 74 in June 2020 for informational purposes. Members were asked to provide comments in-period, with a plan to approve the ED in September 2020.

Analysis

In-Period Changes

6. Staff reviewed amendments provided by IPSASB members in Q3 2020 and actioned them as appropriate. Staff responded to members to communicate how their suggestions were addressed. Changes have been tracked (see Agenda Item 4.3.1)

ED 74, Amendments to IPSAS 5, *Borrowing Costs*

7. Staff has developed the following amendments to IPSAS 5, Borrowing Costs:

   (a) **Basis for Conclusions**. Guidance added to explain:

      (i) The IPSASB decision to maintain the accounting policy choice (BC3 – BC9);

      (ii) The IPSASB decision to add IGs and IEs (BC10); and

(iii) The difference between borrowing costs and transaction costs (BC11 – BC14).

(b) **Implementation Guidance**. Guidance added to clarify the interpretation of “qualifying asset” and “directly attributable” expenditures.

(i) Period of Borrowing Cost Capitalization (A.1);

(ii) Limit on Capitalization (A.2);

(iii) Asset Funded through Appropriations (A.3);

(iv) Asset Funded through a Centralized Borrowing Program – Interest Rates (A.4);

(v) Asset Funded through an Entity’s Own General Borrowing – Borrowings are not Specific to Qualifying Asset (A.5); and

(vi) Asset Funded through Specific Borrowings – Range of Debt Instruments (A.6).

(c) **Illustrative Examples**. Examples added to clarify the interpretation of “qualifying asset” and “directly attributable” expenditures.

(i) Qualifying Asset Constructed Over a Period of Time (IE1- IE3);

(ii) Centralized Borrowing Program – Eligible Borrowing Costs (IE4 – IE8);

(iii) General Borrowing – Weighted Average Cost of Borrowing (IE9 – IE12); and

(iv) Specific Borrowing – Borrowing for Part of Qualifying Asset’s Amount (IE13 – IE14).

Decision Required

8. No decision required.

Approval: ED 74, Amendments to IPSAS 5, *Borrowing Costs*

Question

1. Does the IPSASB:

   (a) Agree there are no additional issues to be discussed by the IPSASB at this time;

   (b) Agree the title of the document is appropriate;

   (c) Approve ED 74, Amendments to IPSAS 5, *Borrowing Costs* for exposure; and

   (d) Agree an exposure period ending March 1, 2021 is appropriate.

Recommendation

2. Staff and the Board member sponsor recommend ED 74, Amendments to IPSAS 5, *Borrowing Costs* be approved for exposure.

Due Process

3. The IPSASB released its Consultation Paper, *Measurement* in April 2019. The exposure period closed October 14, 2019.

4. Prior to the December 2019 IPSASB meeting, the IPSASB CAG discussed the responses to the Consultation Paper. The CAG provided input for the IPSASB to consider as part of its analysis.

5. The IPSASB performed an initial review of responses in December 2019 and provided staff with direction in how to proceed. Members encouraged Staff to develop a recommendation and draft guidance for the March 2020 meeting to close this issue.

6. The IPSASB reviewed draft versions of ED 74 in March 2020 and June 2020. Members provided comments to improve ED 74 which have been actioned by Staff.

Exposure Period

7. Staff proposes releasing the document during October 2020. Staff recommends setting Monday, March 1, 2021 as the comment deadline to allow for a 4-month exposure period.

Document Title

8. As the exposure draft amends guidance in IPSAS 5, staff proposes the title Amendments to IPSAS 5, *Borrowing Costs*. However, this may not capture targeted changes of the project. Staff also considered:

   (a) [draft] IPSAS [X] (ED 74), *Clarification of the Terms Qualifying Assets and Directly Attributable*; and

   (b) [draft] IPSAS [X] (ED 74), Amendments to IPSAS 5, *Borrowing Costs*, Clarification of the Terms Qualifying Assets and Directly Attributable

   Staff welcomes views from the IPSASB regarding the appropriate title for the document

Decision Required

9. Does the IPSASB agree with the Staff recommendation?

Agenda Item 4.3.1

Supporting Documents 1 - ED 74, Amendments to IPSAS 5, *Borrowing Costs*

1. This Agenda Item includes a draft version of ED 74. This version reflects changes since the Q2 2020 version reviewed by the IPSASB.

Review Instructions

2. IPSASB members, Technical Advisors, and Observers are asked to note the following when reviewing ED 74:

    (a) Amendments proposed to IPSAS 5, *Borrowing Costs* are based on decisions made by the IPSASB in March 2020.

    (b) This version of the document reflects all changes instructed by the IPSASB since March 2020. Changes since June 2020 are tracked.

        (i) Changes in June 2020 are based on in-period instructions received from individual IPSASB members;

    These components are formatted as follows for easier reference:

Format	Format description
Text	Paragraphs reviewed by IPSASB in June 2020 are shaded grey
Track changes	Text changed through in-period instructions or editorial updates is tracked

Exposure Draft 74
Month, 2020
Comments due: March 1, 2021

IPSAS®

Proposed International Public Sector Accounting Standard®

~~Improvements~~ Amendments to IPSAS 5, *Borrowing Costs*

IPSASB International Public Sector Accounting Standards Board®

International Public Sector Accounting Standards Board®

This document was developed and approved by the International Public Sector Accounting Standards Board® (IPSASB®).

The objective of the IPSASB is to serve the public interest by setting high-quality public sector accounting standards and by facilitating the adoption and implementation of these, thereby enhancing the quality and consistency of practice throughout the world and strengthening the transparency and accountability of public sector finances.

In meeting this objective the IPSASB sets IPSAS® and Recommended Practice Guidelines (RPGs) for use by public sector entities, including national, regional, and local governments, and related governmental agencies.

IPSAS relate to the general purpose financial statements (financial statements) and are authoritative. RPGs are pronouncements that provide guidance on good practice in preparing general purpose financial reports (GPFRs) that are not financial statements. Unlike IPSAS RPGs do not establish requirements. Currently all pronouncements relating to GPFRs that are not financial statements are RPGs. RPGs do not provide guidance on the level of assurance (if any) to which information should be subjected.

The structures and processes that support the operations of the IPSASB are facilitated by the International Federation of Accountants® (IFAC®).

REQUEST FOR COMMENTS

This Exposure Draft, ~~Improvements~~ Amendments to IPSAS 5, *Borrowing Costs*, was developed and approved by the International Public Sector Accounting Standards Board® (IPSASB®).

The proposals in this Exposure Draft may be modified in light of comments received before being issued in final form. **Comments are requested by March 1, 2021.**

Respondents are asked to submit their comments electronically through the IPSASB website, using the "Submit a Comment" link. Please submit comments in both a PDF and Word file. Also, please note that first-time users must register to use this feature. All comments will be considered a matter of public record and will ultimately be posted on the website. This publication may be downloaded from the IPSASB website: www.ipsasb.org. The approved text is published in the English language.

Objective of the Exposure Draft

Exposure Draft (ED) XX, ~~Improvements~~ Amendments to IPSAS 5, *Borrowing Costs*, deals with non-substantive changes to IPSAS that arose through comments received from stakeholders in response to the IPSASBs Consultation Paper, *Measurement*.

Based on stakeholder responses, the IPSASB agreed to retain the existing policy choice whether to expense or capitalize qualifying borrowing costs. The IPSASB also agreed to develop Implementation Guidance and Illustrative Examples to better explain the concepts of qualifying asset and directly attributable.

Guide for Respondents

The IPSASB would welcome comments on all of the matters discussed in this Exposure Draft. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

The Specific Matters for Comment requested for the Exposure Draft are provided below.

~~**Specific Matter for Comment 1:**~~

~~Do you agree with the IPSASBs proposal that the policy choice available to capitalize or expense borrowing costs directly attributable to a qualifying asset is retained for the public sector? If not, why not?~~

Specific Matter for Comment ~~2~~1:

Do you agree with the guidance developed in the illustrative examples and implementation guidance? If not, what further guidance is necessary?

Objective

1. The objective of this Exposure Draft (ED) is to propose amendments to IPSAS 5, *Borrowing Costs*, to provide interpretive guidance for the terms “qualifying asset” and “directly attributable”. No amendments are proposed to the authoritative material. The proposed amendments add implementation guidance and illustrative examples. The IPSASB’s decisions are explained in the amended Basis for Conclusions which are the first item in this ED.

2. This ED forms part of the IPSASB’s measurement project. This ED is released independent from the Measurement ED as decisions related to borrowing costs were made in isolation of, and have little impact on, the broader measurement project.

3. This ED specifically addresses the preliminary view proposed in the IPSASB’s April 2019 Measurement Consultation Paper that proposed all borrowing costs be expensed. The complexity of this issue, and the divided responses received, resulted in the IPSASB agreeing to retain the existing accounting policy choice in IPSAS 5. However, additional guidance to support constituents in determining when borrowing costs could be capitalized is proposed in this ED.

Request for Comments

4. The IPSASB would welcome comments on all the matters proposed in the ED. Comments are most helpful if they indicate the specific paragraph or group of paragraphs to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.

Summary of Proposed Changes

Section of IPSAS 5, *Borrowing Costs*	***Summary of Proposed Change***
Basis for Conclusions	• The IPSASB decision to retain the accounting policy choice to capitalize borrowing costs as part of the cost of the asset when they are directly attributable to the acquisition, construction, or production of a qualifying asset (BC3 – BC9); • The IPSASB decision to add Implementation Guidance and Illustrative Examples (BC10); and • The difference between borrowing costs and transaction costs (BC11 – BC14).
Implementation Guidance	Guidance added to clarify the interpretation of “qualifying asset” and “directly attributable expenditures”.
Illustrative Examples	Examples added to clarify the interpretation of “qualifying asset” and “directly attributable expenditures”.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 5.

…

Revision of IPSAS 5 as a result of the IPSASB's Consultation Paper, *Measurement*, issued in April 2019

BC3. In April 2019, the IPSASB published a Consultation Paper, *Measurement*. The Consultation Paper proposed a comprehensive framework outlining how measurement bases should be determined when applied in the context of IPSAS. One of the objectives of the Consultation Paper was to consider the existing requirements on accounting for borrowing costs in IPSAS 5, *Borrowing Costs*.

BC4. The Consultation Paper discussed the accounting policy choices permitted in IPSAS 5 for accounting for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset: capitalization or immediate recognition as an expense.

BC5. The Board proposed to eliminate the option to capitalize borrowing costs in order to:

(a) Address a public sector issue where borrowing is centralized and determined for the economic entity as a whole. Expensing borrowing costs lessens the burden of attributing centralized borrowing costs to specific projects within the public sector;

(b) Enhance comparability between the cost of asset acquisitions, productions or constructions between public sector entities; and

(c) Align more closely with the requirements in the Government Finance Statistics Manual (GFS).

BC6. In developing its preliminary view, the Board acknowledged the complexity of the issue. This complexity, and opposing views on what should be included in cost, resulted in responses to the preliminary view being split with many respondents supporting the Board's proposal, and equally, many respondents disagreeing. Those that disagreed noted the reasons to remove the existing accounting policy choice were insufficient, arguing that:

(a) Difficulties in attributing borrowing costs to specific projects in the public sector are exaggerated and are an insufficient reason to diverge from private sector accounting treatment. Large conglomerates in the private sector face similar challenges and are able to capitalize borrowing costs;

(b) Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are part of the cost of that asset. During the period when an asset is under development, the expenditures for the resources used must be financed. Financing has a cost. The cost of the asset should include all costs necessarily incurred to get the asset ready for its intended use or sale, including the cost incurred in financing the expenditures as a part of the asset's acquisition, construction or production cost;

(c) Capitalizing directly attributable borrowing costs enhances accountability and decision making; and

(d) Immediate expensing of borrowing costs leads to inconsistency in treatment with the requirement to capitalize transaction costs directly attributable to the acquisition of an asset.

BC7. Having reviewed the responses, the Board concluded the existing accounting policy best represented the diversity in views and should be ~~maintained~~retained.

BC8. The Board observed the existing accounting policy choice is consistent with the measurement principles in the Conceptual Framework and allows preparers of public sector financial statements to weigh the qualitative characteristics of useful information when selecting an approach that most faithfully represents the cost of the asset.

BC9. Further supporting its conclusion to ~~maintain~~ retain the accounting policy choice, the Board noted the following:

(a) The technical merits of capitalizing borrowing costs or expensing borrowing costs both have value. In some cases, respondents took opposite views: for example, on whether borrowing costs are an attribute of the cost of an asset;

(b) The goal of the approach when accounting for borrowing costs is to assist financial statement users in obtaining the most appropriate reflection of costs to acquire, construct or develop an asset, which may in some cases include borrowing costs;

(c) While at certain levels of government the allocation of borrowing costs is challenging, at other levels, such as at local governments, it can be relatively straightforward;

(d) Capitalization of borrowing costs would align with IFRS where that is an economic entity's preferred approach, whereas the expensing of borrowing costs would demonstrate alignment with GFS if that is an economic entity's preferred approach; and

(e) There ~~must~~ needs to be a clear benefit to expensing all borrowing costs if the current accounting policy choice was to be removed. Since there are unavoidable costs in eliminating an accounting policy choice, the Board carefully considers the costs and benefits of any new pronouncement. In this case, the Board has not been told that preparers who elected to capitalize borrowing costs under IPSAS 5 found doing so unnecessarily burdensome.

BC10. In order to support those respondents that identified practical public sector challenges in capitalizing borrowing costs, the Board developed Implementation Guidance and Illustrative Examples to address the application of the concepts of Qualifying Asset and Directly Attributable.

Distinction between borrowing costs and transaction costs

BC11. In reaching the conclusion to retain the accounting policy choice, the IPSASB noted accounting for borrowing costs may not be consistent with accounting for transaction costs. Some respondents proposed that the accounting treatment of borrowing costs and transaction costs should be consistent because they considered either:

(a) Borrowing costs to be a type of transaction costs. Borrowing costs are directly attributable to the borrowing (for example, the issuance of a government financial instrument). Therefore, they meet the criteria of a transaction cost; or

(b) Transaction costs to be a type of borrowing costs. Some respondents proposed this view based on the methodology applied in calculating the effective interest rate of a financial instrument. This is because some transaction costs are added to, or subtracted from, the principal amount of a financial instrument when determining the gross proceeds of a borrowing in order to determine the effective interest rate.

BC12. The Board considered these views, but maintained that borrowing costs and transaction costs are different economic phenomena. The Board concluded it is appropriate for the accounting principles to differ for each type of "cost" depending on the facts and circumstances.

BC13. In reaching this view, the Board noted that borrowing costs comprise interest and other expenses incurred by an entity in connection with borrowing funds. Borrowing costs are often contractually linked to the underlying borrowing. Should the borrowing be transferred, the borrowing costs would either be transferred to the new counterparty or separated contractually. For example, Entity A has a mortgage with a fixed interest rate with a financial institution. Entity A pays Entity B to take over the mortgage. This transfer includes all future principal and interest payments.

BC14. Transaction costs are incremental costs directly attributable to the transaction. However, transaction costs are independent of the contractual terms of the instrument. Should the item be transferred, the entity transferring the item is generally not compensated for the transaction costs because they are not transferred to the counterparty assuming the item. For example, Entity A paid a transaction fee equal to 1% of the mortgage balance to enter into the transaction with the financial institution. Entity A pays Entity B to take over the mortgage. However, while the transfer includes all future principal and interest payments, it excludes the transaction costs Entity A incurred to enter into the transaction with the financial institution.

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 5.

A.1 Period of Borrowing Cost Capitalization ~~Timing of Qualifying Assets~~

When applying the allowed alternative treatment, as described in paragraph 17–18, when can borrowing costs be included in the cost of the qualifying asset?

Where borrowings have been incurred specifically to fund an asset's construction, the costs of those borrowings cannot be capitalized in the period before the commencement of the activities necessary to get the asset ready for use. However, the activities necessary to get the asset ready for use encompass more than the asset's physical construction. They include technical and administrative work prior to the commencement of physical construction. However, they exclude holding the asset when no production or development that changes the asset's condition is being undertaken.

A.2 Limit on Capitalization

When applying the allowed alternative treatment, as described in paragraph 17–18, to specific borrowings, are borrowing costs included in the cost of the qualifying asset limited to the borrowing costs incurred in that period?

Yes. If a borrowing can be specifically associated with expenditures on construction or production of the asset, the amount of borrowing costs capitalized is limited to the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

A.3 Asset ~~funded~~ Funded through Appropriations

In many jurisdictions, the entity acquiring, constructing, or producing the qualifying asset, is funded through an appropriation. ~~If the~~Does the entity constructing the qualifying asset ~~is unaware~~consider ~~of~~ the underlying source of the funds, i.e., whether they are generated by tax revenues, general cash holdings or borrowings, ~~is the entity required to consider the original source of the funds~~ when it determines the amount that can be included in the cost of the qualifying asset when applying the allowed alternative treatment, as described in paragraph 17–18?

No. When ~~an entity constructing~~ the acquisition, construction or production of a qualifying asset is fully funded~~the qualifying asset is funded~~ through an appropriation, there will be no directly attributable borrowing costs to capitalize. ~~t~~The entity may include in the cost of the qualifying asset ~~only~~ those borrowing costs which itself has incurred.

A.4 Asset ~~funded~~ Funded through a Centralized Borrowing Program – Interest Rates

A ~~C~~centralized borrowings agency may ~~be~~ fund~~ed~~ its borrowings through several separate loan instruments. Each instrument may have a different interest rate. An ~~Does the~~ entity may borrow funds from the centralized borrowing agency and use these funds in the construction of ~~aconstructing~~ ~~the~~ qualifying asset. If the constructing entity is using the allowable alterative treatment, as described in paragraph 17–18, ~~and borrowing from the centralized borrowing agency apply the centralized borrowing agency's~~ does the constructing entity apply the interest rate

incurred by the centralized borrowing agency when including borrowing costs in the cost of the qualifying asset ~~when applying the allowed alternative treatment~~?

No. The weighted average rate incurred by the centralized borrowing agency ~~borrowing entity~~ is not relevant in the preparation of the financial statements of the entity constructing the qualifying asset. The constructing entity can include in the cost of the qualifying asset only those borrowing costs which itself has incurred. ~~The entity considers only the interest rate it incurs in its arrangement with the centralized borrowing agency.~~

The constructing entity must consider all facts and circumstances when determining the borrowing costs incurred in its arrangement with the centralized borrowing agency. In some cases, the interest rate stated in the terms of the arrangement may not reflect the true borrowing costs associated with the funds received. When the constructing entity identifies concessionary terms, the constructing entity should apply the requirements in IPSAS 41, paragraphs AG118–AG127[1] and capitalize borrowing costs based on a market related interest rate that the constructing entity would have incurred on a similar loan. Interest expense calculated using the effective interest rate method is eligible for inclusion in the cost of the qualifying asset in accordance with this Standard.

A.5 Asset ~~funded~~ Funded through an ~~entity's~~ Entity's ~~own~~ Own General Borrowing – Borrowings are not Specific to Qualifying Asset

When an entity acquiring, constructing, or producing a qualifying asset manages its own borrowing program, but borrowings are not specific to the qualifying asset, how does the entity determine the borrowing costs directly attributable to the qualifying asset? This may occur when an entity uses cash on hand to fund the cost of a qualifying asset. This cash on hand is funded from general borrowings, tax revenue and other fees and transfers.

The amount of borrowing costs eligible for inclusion ~~of~~ in the cost of the qualifying asset ~~are~~ is determined using the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period. The weighted average of borrowing costs is then applied to the outlays on the qualifying asset incurred during the period in determining the amount eligible for capitalization.

The entity shall exclude from the weighted average calculation, those borrowings that are made specifically for the purpose of obtaining another qualifying asset until substantially all the activities necessary to prepare that asset for its intended use are complete.

A.6 Asset ~~funded~~ Funded through Specific Borrowings – Range of Debt Instruments

Does an entity apply a weighted average of borrowing costs when multiple debt instruments are used to fund the cost of a qualifying asset?

[1] Where an entity has not yet adopted IPSAS 41, the requirements in IPSAS 29, paragraphs AG84-AG90 are applied. Similar to the IPSAS 41 requirements, an entity should capitalize borrowing costs based on a market related interest rate that the constructing entity would have incurred on a similar loan.

Yes. An entity may not be able to fund the cost of a qualifying asset with a single debt instrument. When multiple debt instruments are used, the cost of borrowing is determined by calculating the weighted average of all the debt instruments used to fund the cost of the qualifying asset.

Illustrative Examples

These examples accompany, but are not part of, IPSAS 5.

~~Timing of~~ Qualifying Asset~~s~~ Constructed Over a Period of Time

IE1. On March 31, 20x1, Municipality XYZ begins construction of a tunnel to accommodate transit between two commercial hubs. The construction period is 5-years and the project is budgeted to cost CU100 million (CU20 million per year is paid to the construction company on March 31 of each year). Municipality XYZ issues a 25-year CU100 million bond on March 31, 20x1 that yields a fixed coupon of 5 percent per annum. This bond was issued specifically to finance the construction of this project.

IE2. On December 31, 20x1, the Municipality has accrued borrowing costs of CU3.75 million (CU100 million x 5 percent x 9/12 months). In determining the borrowing costs that can be included in the cost of the tunnel, the Municipality is limited to the actual amount incurred in the production of the qualifying asset.

IE3. At December 31, 20x1, Municipality XYZ recognizes their tunnel asset as a work in progress. The amount capitalized is CU20.75 million (CU20 million + CU20 million x 5 percent x 9/12 months). This represents the funds transferred to the construction company and the borrowing costs associated with that amount. Municipality XYZ recognizes interest expense of CU3 million (CU80 million x 5 percent x 9/12 months) related to borrowing costs not specifically associated with expenditures on construction of the tunnel.

Centralized Borrowing Program – Eligible Borrowing Costs

IE4. The Department of Infrastructure begins construction~~s~~ of a new road network on June 15, 20x1. The project costs are budgeted to be CU500 million. All financing required by the Department of Infrastructure, and all other government departments, is secured centrally by the Department of Finance.

IE5. The Department of Finance estimates its cash flow needs on an annual basis in order to determine the most appropriate source of funding to meet its internal lending needs. These sources include tax revenue, fee revenue, bonds issuances and loans.

IE6. The Department of Infrastructure negotiates a 10-year loan from the Department of Finance. The Department of Finance requires the Department of Infrastructure to pay borrowing costs of three percent per annum. This is consistent with the market rate of interest the Department of Infrastructure would incur if the arrangement was negotiated at arm's length.

IE7. When the Department of Infrastructure secures financing from the Department of Finance, the Department of Infrastructure is aware borrowings comprise various sources, but has no visibility into how the Department of Finance sources the funds, nor the weighted average borrowing costs the Department of Finance incurs.

IE8. In determining the borrowing costs eligible for inclusion in the cost of the road network, the Department of Infrastructure includes only those borrowing costs which itself has incurred. Since the loan is at market terms the Department of Infrastructure concludes there are no concessionary elements and determines borrowing costs eligible for inclusion in the cost of the road network are based on the interest rate of 3 percent stated in the contract.

General Borrowing – Weighted Average Cost of Borrowing

IE9. State Government T has begun construction of a new airport. The cost of this Airport is budgeted to be CU500 million. State Government T manages its own borrowings; however, it does not borrow for specific projects. In determining its borrowing needs, State Government T budgets its cash short fall over a given period and ensures borrowings will cover its liquidity needs.

IE10. Over the construction period, State Government T held three instruments that were open for the entire construction period:

- State Bonds – CU1 Billion, yielding an annual rate of 5 percent;
- Loan with Financial Institution A – CU300 million, with an annual interest rate of 7 percent; and
- Loan with Financial Institution B – CU600 million, with an annual interest rate of 9 percent.

IE11. In determining the amount of borrowing costs eligible for inclusion of the cost of the Airport, State Government T calculates the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period.

	A Principal	B Interest Rate	C Proportion of Debt	D (B x C) Weighted Average
State Bonds	CU1,000 million	5 percent	1,000 / 1,900	2.63
Loan A	CU300 million	7 percent	300 / 1,900	1.11
Loan B	CU600 million	9 percent	600 / 1,900	2.84
Weighted Average				**6.58 percent**

IE12. State Government T calculates the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period to be 6.58 percent.

Specific Borrowing – Borrowing for Part of Qualifying Asset's Amount

IE13. State Government C began construction of a new road network on January 1, 20x1. The cost of this road network is budgeted to be CU750 million. State Government C funds this project with amounts received on January 1, 20x1 from two sources:

- Federal grant in the amount of CU500 million; and
- Loan from a financial institution of CU250 million, with an annual interest rate of 5 percent.

IE14. On December 31, 20x1, State Government C has incurred outlays of CU200 million. In addition to the outlays of CU200 million, State Government C capitalizes CU10 million (CU200 million x 5 percent) in borrowing costs, against the qualifying asset.

IE15. Since State Government C borrowed CU250 million for the purposes of obtaining the road network, but has only incurred outlays related to that qualifying asset in the amount of CU200 million, State Government C concludes the amount of borrowing costs eligible for capitalization are limited to the interest incurred on the outlays related to the qualifying asset in the period.

Published by: International Federation of Accountants®

(Back cover)

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