CAPITALIZATION OF BORROWING COSTS: THE PHILOSOPHY OF THE INTERNATIONAL FINANCIAL REPORTING STANDARDS COMPARED TO THE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES OF THE UNITED STATES

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Abstract: The issue of capitalization of borrowing costs has raised numerous debates in Europe, South Africa, United States, Australia, New Zealand, and elsewhere around the world. For decades now the problem has been the subject of comprehensive deliberations and insights among both scientific and professional community.
The matter of capitalizing borrowing costs, central to the present article, is discussed and analyzed from theoretical and methodological perspective. The prescriptions of the International Financial Reporting Standards are interpreted and compared to the relevant guidelines into the Generally Accepted Accounting Principles, applied in the United States, in consistency with the author's primary aim to highlight the most important similarities and dissimilarities, and reveal on the basis of comparative analysis the underlying philosophy of the relevant standards.
Keywords: International Accounting Standards, International Financial Reporting Standards, U.S. Generally Accepted Accounting Principles, International Accounting Standards Board, Financial Accounting Standards Board, convergence, international financial reporting;

1. INTRODUCTION

The International Accounting Standards Board (IASB) considerably[5] amended parts of International Accounting Standard 23 *'Borrowing costs'*[6] (2009) to achieve greater degree of convergence with the U.S. GAAP's rules. The general principles of the IAS 23 (Revised) come to be the same as those underlying the Statement of Financial Accounting Standards (SFAS) 34 *'Capitalisation of interest cost'*[7]. However, a closer look reveals that the details differ. *SFAS 34 (FASB, 1979, paragraph 39) states that interest capitalization is necessary because expenditures… used in creating the asset must be financed. Financing has a cost. The cost may take the form of explicit interest on borrowed funds, or it may take the form of a return forgone on an alternative use of funds, but regardless of the form it takes, a financing cost is necessarily incurred* (H. A. Mozes and A. I. Schiff, 1995, p. 1). The revised Standard requires borrowing costs incurred to finance processes of acquirement, construction or production of qualifying assets to be capitalised as a comprising component of the historical cost of acquisition or construction. Convergence at this high level of uniformity was relatively not difficult to achieve, with the consensus or maybe the compromise on the part of IASB to eliminate the predominant accounting treatment (option) to expense all interest under the IAS 23, before the revision.
Critical questions about the practical implementation of the new requirements emerged after the Standard's release in contrast with the expectations that the change would be straightforward. Relatively rare preparers under IFRS had been capitalising interest, and probably the regulatory change regarding IAS 23 approaches had not been the subject of much scrutiny or debate among the members of the Board (IASB). Some of the questions seem related to the rules-based nature of IAS 23. It requires borrowing costs to be capitalised, however it prohibits consideration of the cost of equity, 'cost of equity' is not considered when arriving at net profit or loss. Therefore, there is a distinction from borrowing costs. The IAS 23 may give a more complete picture of the costs incurred by an entity for qualifying assets but many experts would observe that this might be more accurate, but is less relevant, driven by a rule-based requirement.

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[5] Commission Regulation (EC) No 70/2009 of 23 January 2009 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards Improvements to International Financial Reporting Standards (IFRSs), OJ L 21, 24.1.2009, p. 16–37. http://data.europa.eu/eli/reg/2009/70/oj
[6] Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (Text with EEA relevance) http://data.europa.eu/eli/reg/2008/1126/2020-01-01
[7] In 1974, the Securities and Exchange Commission (SEC) noted that an increasing number of companies were capitalizing interest costs, and that this practice was not being adequately disclosed (FASB, 1979, paragraph 26). In light of the alternative practices concerning the accounting for interest and lack of adequate disclosure by companies that were already capitalizing interest, the SEC recommended that the Financial Accounting Standards Board (FASB) consider the issue of accounting for interest cost. As a result of the SEC's initiative, in 1979 the FASB issued Statement of Financial Accounting Standards (SFAS) No. 34 *'Capitalization of Interest Cost'*, which mandated uniform interest capitalization rules in accounting for interest costs, associated with the acquisition of qualifying non-current assets. https://www.fasb.org/summary/stsum34.shtml

Convergence through eliminating the option to expense borrowing costs may be perceived as if the IASB did not reconsider in depth the requirements of IAS 23. Challenges remain about how to treat specific borrowings, contrasting to the accounting for general borrowings, when to start capitalisation in some situations, and whether the exemptions regarding the scope are mandatory or optional.

2. SCOPE AND KEY DEFINITIONS OF THE INTERNATIONAL ACCOUNTING STANDARD (IAS) 23 *'BORROWING COSTS'*

An entity that prepares its financial statements of general purpose using IFRS as a normative base must apply the rules of IAS 23 in accounting for borrowing costs.
As previously mentioned, the IAS 23 does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability. 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, for example a biological asset within the scope of IAS 41 *'Agriculture'*; or
- Inventories that are manufactured or produced otherwise in large quantities on a repetitive basis.

Borrowing costs *are interest and other costs that an entity incurs in connection with borrowing of funds.*
A qualifying asset *is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale*. Shortcoming of the Standard is that it does not determine *"a substantial period of time".* Our research find out that the perceptions are widely ranging globally, from 3 months to three years[8]. ***Borrowing costs*** may include interest expenses calculated using the method of the effective interest as described in IFRS 9 *'Financial Instruments'*; interest in respect of liabilities on leases recognised in accordance with IFRS 16 *'Leases'*; and exchange differences arising from foreign currency borrowings *to the extent that they are regarded as an adjustment to the interest costs*.
Depending on the circumstances any of the following may be qualifying assets: inventories; manufacturing plants; power generation facilities; intangible assets; investment properties; bearer plants.
Financial assets and inventories that are manufactured or otherwise produced, over a short period of time, are not qualifying assets as well as assets that are ready for their intended use or for sale when acquired.

3. CRITERIA FOR RECOGNITION OF BORROWING COSTS ACCORDING TO IAS 23[9]

An entity should capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity should recognise other borrowing costs as an expense in the period, in which the entity incurs them. *Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset*. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. When an entity applies IAS 29 *'Financial Reporting in Hyperinflationary Economies'*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with paragraph 21 of the Standard.

4. BORROWING COSTS ELIGIBLE FOR CAPITALISATION:[10] ESSENCE OF THE BASIC RULES

The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs *that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified*.
In some cases it may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is coordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. *As a*

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[8] Staden, L. Van (2010) Technical uncertainties and practical implications of the capitalisation of borrowing costs in South Africa.
[9] IAS 23 as issued by the IASB, paragraphs 8 and 9.
[10] IAS 23 as issued by the IASB, paragraphs 10 and the following ones including 15.

result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

- *To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity should 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.*
- *The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.*
- *To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity should determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity should exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are completed. The amount of borrowing costs that an entity capitalises during a period should not exceed the amount of borrowing costs it incurred during that period.*

In some practical circumstances it is appropriate to include all the borrowings of the parent and its subsidiaries, computing a weighted average of the borrowing costs; in other situations, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

5. EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE VALUE (AMOUNT)

When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other standards, for example IAS 36 *'Impairment of assets',* interrelated with the models of assessment after recognition as described in IAS 16 *'Property, plant and equipment',* IAS 38 *'Intangible assets'*, IAS 40 *'Investment property',* IAS 41 *'Agriculture',* or IAS 2 *'Inventories' and others*. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other standards.

6. COMMENCEMENT OF CAPITALISATION[11]

An entity should 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*n entity incurs expenditures for the asset; an entity incurs borrowing costs; and an entity undertakes activities that are necessary to prepare the asset for its intended use or sale*.

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. Expenditures are reduced by any progress payments received and grants received in connection with the asset, in accordance with IAS 20 '*Accounting for Government Grants and Disclosure of Government Assistance*', more specifically in accordance with the income approach and method of deducting the grant in calculating the carrying amount of the asset. Subsequently the grant is recognised in profit or loss over the probable useful life of the depreciable asset as a reduced expenses of depreciation.[12]

The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures, to which the capitalisation rate is applied in that period. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset such as technical and administrative work prior to the commencement of physical construction, for example, the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period, in which activities related to the development are being undertaken.

[11] IAS 23 as issued by the IASB, paragraphs 17-19.
[12] Under the other allowed method the grant is recognised as deferred income that is recognised in profit or loss on a systematic basis over the useful life of the asset.

However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

7. WHEN CAPITALISATION TO BE SUSPENDED?[13]

An entity should suspend capitalisation of borrowing costs during extended periods, in which it suspends active development of a qualifying asset. An entity may incur borrowing costs during an extended period, in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also 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. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

8. CESSATION OF CAPITALISATION[14]

An entity should cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or for sale are completed. An asset is normally ready for its intended use or sale when the physical construction of the asset is completed even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are completed. When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction on other parts continues, the entity should cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale. 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. An example of a qualifying asset that needs to be completed before any part can be used is an industrial plant involving several processes, which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

9. REQUIREMENTS OF DISCLOSURE AND TRANSITIONAL PROVISIONS UNDER IAS 23 'BORROWING COSTS'

An entity should disclose:

- The amount of borrowing costs capitalised during the period; and
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

When application of this Standard constitutes a change in accounting policy, an entity should apply the Standard to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the effective date (paragraph 27). An entity may designate any date before the effective date and apply the Standard to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date (paragraph 28). Annual Improvements to IFRS 2015–2017 Cycle, issued in December 2017, amended paragraph 14. An entity shall apply those amendments to borrowing costs incurred on or after the beginning of the annual reporting period, in which the entity first applies those amendments (paragraph 28A).

10. EFFECTIVE DATE[15]

An entity should apply the IAS 23 for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Standard from a date before 1 January 2009, it shall disclose that fact. Paragraph 6 was amended by Improvements to IFRSs issued in May 2008. An entity should apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it should disclose that fact 2 (paragraph 29A). IFRS 9, as issued in July 2014, amended paragraph 6. An entity should apply that amendment when it applies IFRS 9, (paragraph 29B). IFRS 16, issued in January 2016, amended paragraph 6. An entity should apply that amendment when it applies IFRS 16 (paragraph 29C). Annual Improvements to IFRS 2015-2017 Cycle, issued in December 2017, amended paragraph 14 and added paragraph 28A. An entity should apply those amendments for annual reporting periods beginning on or after 1

[13] IAS 23 as issued by the IASB, paragraphs 20-21.
[14] IAS 23 as issued by the IASB, paragraphs 22-25.
[15] IAS 23 Borrowing Costs as issued by the IASB, paragraphs 29, 29A, 29B, 29C, 29D.

January 2019. Earlier application is permitted. If an entity applies those amendments earlier, it should disclose that fact (paragraph 29D).

11. MAJOR DISSIMILARITIES BETWEEN IFRS[16] AND U.S. GAAP[17]

Many comparative analyses in the specialized literature and interpretations reveal multiple differences with the potential for different applications to similar arrangements. The guidance for capitalization of borrowing costs under IAS 23 and of interest under U.S. GAAP are converged at high level. However, differences in the detailed requirements exist. For example, Amit Singh and Valerie Boissou[18] [19] on the basis of comparison discussed how IAS 23 is different from U.S. GAAP and outlined the major differences?

On the subject of the scope and the essence of the qualifying assets

U.S. GAAP has specialized industry guidance while IFRS do not. U.S. GAAP includes specialized guidance for several industries, including real estate and oil and gas producing activities, which may lead to different qualifying assets. IAS 23 applies similarly to all companies, although there is specific guidance on exploration and evaluation of mineral resources.

As pointed out previously, certain inventory may be a qualifying asset under IAS 23 but may not be under U.S. GAAP. Inventory that takes a long time to be produced but is otherwise produced in large quantities on a repetitive basis, e.g. a kind of wine or cheese, or whisky can be a qualifying asset under IFRS. Under U.S. GAAP a qualifying asset could be either an asset constructed or produced for own use or an asset intended for sale or lease that is constructed or produced as a 'discrete project'. In either case, costs are separately accumulated, and construction of the asset takes considerable time and entails substantial expenditures (e.g. ships or real estate developments). Inventory that takes a long time to produce but is otherwise produced in large quantities on a repetitive basis is not a qualifying asset under U.S. GAAP because it's not produced for a company's own use or as a discrete project.

Internally generated intangible assets other than internally generated goodwill can met the criteria for qualifying assets under IAS 23, but cannot under U.S. GAAP

The accounting for research and development costs under IFRS can be significantly more complex than under U.S. GAAP. Under U.S. GAAP research and development (R&D) costs within the scope of the Accounting Standard Codification (ASC) 730[20] *are expensed as incurred*. U.S. GAAP also contain specific requirements for motion picture films, website development, cloud computing costs and software development costs. Under IFRS and specifically IAS 38 *'Intangible assets'* research costs are expensed like in accordance with U.S. GAAP. Based on these criteria, internally developed intangible assets (e.g. development expenses related to a prototype in the automotive industry) are generally capitalized and amortized under IFRS, and expensed under U.S. GAAP. This difference gives rise to two complexities in applying IFRS: distinguishing development activities from research activities and analyzing whether and when the criteria for capitalizing development expenditures are met. *Under U.S. GAAP both internal research expenditures and development expenditures are expensed as incurred and therefore are not qualifying assets. However, under IFRS, development expenditures are capitalized if certain criteria are met and therefore can be a qualifying asset. Capitalized expenditures for software developed for internal use may be a qualifying asset both under U.S. GAAP and IAS 23*.

Internally generated intangible assets under IAS 38

In IAS 38 *'Intangible assets'* (paragraph 51) it is stated that sometimes it is difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in: (a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and (b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52-67 to all internally generated intangible assets. To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into: a research phase; and a development phase. Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of the IAS 38 *'Intangible assets'* (*paragraph 52*). *If an entity cannot distinguish the*

[16] IAS 23 Borrowing Costs as issued by the IASB.
[17] ASC 835-20 Interest - Capitalization of Interest.
[18] Singh, Amit, KPMG US, and Valerie Boissou, KPMG's Department of Professional Practice. Borrowing costs: Top 10 differences between IFRS and U.S. GAAP. Differences on the capitalization of borrowing costs under IAS 23 and interest costs under U.S. GAAP IFRS Institute, August 30, 2019. Amit Singh is a director in KPMG's Accounting Advisory Services practice.
[19] Valerie Boissou is a partner in KPMG's Department of Professional Practice.
[20] Accounting Standard Codification (ASC) Topic 730 "Research and Development", October 2019.

research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only. However, unlike U.S. GAAP, IFRS (IAS 38, paragraph 53) provides broad-based guidance that requires companies to capitalize development costs, including internal costs, when certain criteria are met.

Research phase under IAS 38[21]

No intangible asset arising from research (or from the research phase of an internal project) should be recognised. *Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred* (*paragraph* 54). *In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred* (*paragraph* 55). Examples of research activities are given in (*paragraph* 56): (a) activities aimed at obtaining new knowledge; (b) the search for, evaluation and final selection of, applications of research findings or other knowledge; (c) the search for alternatives for materials, devices, products, processes, systems or services; and (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development phase under IAS 38[22]

An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, *and only if, an entity can demonstrate all of the following: the technical feasibility of completing the intangible asset so that it will be available for use or sale; (b) its intention to complete the intangible asset and use or sell it; (c) its ability to use or sell the intangible asset; (d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset; (e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; (f) its ability to measure reliably the expenditure attributable to the intangible asset during its development (paragraph 57)*. In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits, because the development phase of a project is further advanced than the research phase (paragraph 58). Examples of development activities are: the design, construction and testing of pre-production or pre-use prototypes and models; the design of tools, jigs, moulds and dies involving new technology; the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services (IAS 38 *'Intangibles Assets'*, paragraph 59).

To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in IAS 36 *'Impairment of assets'*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in IAS *36 'Impairment of assets'*.

Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan (paragraph 60). An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licenses or developing computer software (paragraph 62). Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets (paragraph *63*). Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets (paragraph 64).

Investments accounted for by the equity method

Investments accounted for by using the equity method are not qualifying assets under IAS 23, but may be under U.S. GAAP that allows an investment accounted for by the equity method to be a qualifying asset, if the investee has activities in progress necessary to commence its planned principal operations and the investee's activities include the use of funds to acquire qualifying assets for its operations.

[21] See IAS 38 Intangibles Assets as issued by the IASB, paragraphs 55-56.
[22] See IAS 38 Intangibles Assets as issued by the IASB, paragraphs 57-59.

Interest on leases includes all leases under IAS 23, but only finance leases under U.S. GAAP
Under IFRS[23] lessees generally recognize all leases on the balance sheet and companies now capitalize eligible interest on any lease liability. Under U.S. GAAP the new definition of interest costs only includes interest related to finance lease determined under Accounting Standard Codification (ASC) 842[24].

Foreign exchange gains or losses may be eligible interest under IAS 23
Borrowings are often obtained in foreign currency, e.g. to offset currency exposure related to the qualifying asset. *IAS 23 includes in 'borrowing costs' foreign exchange differences to the extent such differences are regarded as an adjustment to interest costs. Judgment is therefore required to determine which foreign exchange differences are eligible interest. Unlike IAS 23, U.S. GAAP excludes foreign exchange gains or losses from eligible interest*.

U.S. GAAP has prescriptive guidance on derivative gains or losses, IAS 23 does not
Derivative instruments such as interest rate swaps are commonly used to manage interest rate risk on borrowings. IAS 23 is silent on whether eligible interest includes derivative gains and losses that are used to hedge interest rate risk. In experts' view, such as Singh, A. and V. Boissou, payments and accruals of interest under interest rate swaps that are economic hedges of eligible borrowing costs may be eligible for capitalization. However, changes in fair value of interest rate swaps are not.

U.S. GAAP generally excludes fair value gains or losses on derivatives from eligible interest. However, there are exceptions for fixed-rate debt designated as the hedged item in a fair value hedge. Also, amounts in accumulated other comprehensive income related to cash flow hedges of borrowings whose interest is capitalized are reclassified to earnings over the useful life of the asset – which would be the same period over which the associated capitalized interest is amortized[25].

Income earned on the temporary investment of specific borrowings of funds is deducted under IAS 23, but not under U.S. GAAP
Under U.S. GAAP, interest income on any temporary investment of funds pending expenditure on the asset is not generally offset against interest costs in determining either the capitalization rates or limitations on the amount of interest to be capitalized. An exception exists for circumstances involving tax-exempt borrowings that are restricted externally.

12. PRESENTATION AND DISCLOSURE

IFRS allow a policy choice for presentation in the statement of cash flows; U.S. GAAP does not. Under IFRS, a company may make a policy choice for classifying cash flows related to capitalized interest as either investing cash flows, if the other cash payments to acquire the qualifying asset are reflected as investing activities, or consistently with interest cash flows that are not capitalized (either as operating or financing cash flows). U.S. GAAP requires that capitalized interest paid be classified as investing cash flows.

IAS 23 has different disclosure requirements compared to U.S. GAAP. Both GAAPs require disclosure of capitalized borrowing costs. Additionally, IAS 23 requires disclosure of the capitalization rate for borrowing costs, while U.S. GAAP requires disclosure of total interest costs incurred and charged to expense during the period.

Historically, in the U.S. guidance for capitalization of interest cost has been based upon FASB Statement No. 34, *'Capitalization of Interest Cost'*, as amended, and FASB Statement No. 62, *'Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants'*. This guidance was incorporated into the Governmental Accounting Standards Board (GASB) literature by Statement No. 62, *'Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements'*. Paragraph 7 of Statement 62 requires that interest cost that is incurred during the time when a government is bringing a capital asset related to business-type activities to the condition and location necessary for its intended use should be included in the historical cost of the capital asset. Although the Board (GASB) modified the FASB guidance to be consistent with GASB standards – specifically, excluding capital assets related to governmental activities – the guidance was essentially incorporated into Statement 62 as is, without reexamination. Concepts Statement No. 4, Elements of Financial Statements, was issued in June 2007. It defines assets as "resources with present service capacity that the government presently controls." In general, interest cost is reported as an outflow of resources – an expense or expenditure, depending on the basis of accounting. Concepts Statement 4 states, "An outflow of resources is a consumption of net assets by the government that is applicable to

[23] IFRS 16 Leases.
[24] See Accounting Standard Codification (ASC) 842 Leases.
[25] Amit Singh, KPMG US, and Valerie Boissou, KPMG's Department of Professional Practice. Borrowing costs: Top 10 differences between IFRS and U.S. GAAP. Differences on the capitalization of borrowing costs under IAS 23 and interest costs under U.S. GAAP, IFRS Institute, 2019.

the reporting period." Finally, a stakeholder requested the reexamination of the capitalization of interest guidance as a potential simplification project (Capitalization of Interest Cost – Project Plan).

13. CONCLUSION

Borrowing costs under IFRS are broader and can include more components than interest costs under U.S. GAAP. Both frameworks allow for judgments and subjective decisions especially in determination of the rate of capitalization, which could lead to differences in the amount of costs capitalized even under similar conditions. Specialists argue that U.S. GAAP allows for more judgment in the determination of the capitalization rate. IFRS does not permit the capitalization of borrowing costs in relation to accounting for investments by using equity method, whereas U.S. GAAP allow capitalization in certain circumstances.

International Financial Reporting Standards and U.S. Generally Accepted Accounting Principles are converged to relatively high degree on the accounting for borrowing costs, although dissimilarities exist. However, complexities arise in practice when determining qualifying assets, eligible borrowing costs and the amount to be capitalized. Reporting companies preparing their financial statements in accordance with the IFRS and U.S. GAAP should closely assess their methodologies to determine what and how much to capitalize under both accounting frameworks. Companies may take the benefit of the accounting policy choices available under both frameworks to achieve consistency to the extent possible.

The application of IFRS does not necessarily mean that accurate and useful financial information is produced in relation to each accounting object. Based on a study using a sample of German companies, Paananen and Henghsiu (2009) concluded that accounting quality has not improved after the adoption of IFRS, but in fact deteriorated[26]. In a survey of 498 preparers and auditors of accounts by Beattie, Fearnley and Hines (2008), the participants believed that IFRS had undermined UK financial reporting integrity prior to the "credit crunch"[27], thus further supporting this conclusion.

LITERATURE

Commission Regulation (EC) No 1126/2008 of 3 November 2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council (Text with EEA relevance) OJ L 320, 29.11.2008, p. 1–481

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