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Proposed Amendments to IPSAS 5 *Borrowing Costs*

The Australian Accounting Standards Board (AASB) is pleased to submit its comments on the Exposure Draft ED 35 IPSAS 5 *Borrowing Costs*. In formulating these comments, the AASB has sought and considered the views of Australian constituents. These responses are published on the AASB's website: http://www.aasb.gov.au/Work-InProgress/Pending.aspx.

In general, the AASB is in favour of the IPSASB revising IPSAS 5 *Borrowing Costs* in light of the recent revision of IAS 23 *Borrowing Costs* and modifying it to reflect not-for-profit public sector circumstances. However, the AASB particularly does not support the IPSASB departing from IAS 23 by introducing an optional treatment for borrowing costs 'specifically incurred' to finance the acquisition, construction, or production of a qualifying asset. The AASB encourages the IPSASB to reconsider the proposed types of departures from IAS 23, and depart only on the basis of either:

- public sector specific reasons that are consistent with the IPSASB's guidelines for modifying IFRSs; or
- more fundamentally, the conceptual framework.

Guidelines for modifying IFRSs

The IPSASB initiated a continuous improvements project to update existing IPSASs to converge with the latest related IFRSs, to the extent appropriate for the public sector, and has developed guidelines to be used in that process. In the context of those guidelines, the AASB is concerned that the IPSASB has not identified sufficient public sector specific reasons for departing from IAS 23.

The AASB notes that reasons given for departing from IAS 23 in ED 35 about the difficulty in the public sector of associating borrowings with particular qualifying assets are also issues in the private for-profit sector.

One such reason is that borrowing is centralised and funds are borrowed for the entity as a whole. However, this also occurs in many large businesses. For example, a private sector parent entity may raise funds through debt and equity sources for a group of companies and then allocate funding to a particular subsidiary for the construction of a qualifying asset. In such a situation, it would be difficult for the entity to distinguish the proportion of debt financing because financing is provided from a pool of funds.

ED 35 also argues that the large number of controlled entities in the public sector means that tracking borrowing costs can be complex and resource intensive due to the individual accounting systems used by those controlled entities. The AASB notes that this is also a challenge faced by private sector entities that may have hundreds of subsidiaries.

In conclusion, the AASB is not convinced with the arguments put forward to modify IAS 23. In particular, the AASB does not think that the IPSASB has adequately established a basis for introducing the notions of 'specifically incurred' and 'general borrowings' and the consequential different accounting treatments. Consistent with the IPSASB guidelines for modifying IFRSs, the IPSASB should use the IAS 23 notion of 'directly attributable' borrowing costs in IPSAS 5 and thereby keep IAS 23 broadly intact.

Conceptual view

Although the AASB has been unable to identify public sector facts and circumstances to justify a departure from IAS 23, from a conceptual view, the AASB does not support treating borrowing costs differently from other financing costs. The AASB considers that there are sound conceptual arguments for immediately expensing all borrowing costs – that is, treating them as costs of the period in which they are incurred.

Consistent with this, one conceptual response to the issue of accounting for borrowing costs would be to require all financing costs to be capitalised to qualifying assets. That is, if the cost of finance associated with the acquisition, construction, or production of a qualifying asset should be included in its recognised cost, conceptually this should be done regardless of the form that finance takes. There seems little justification for only including the cost of finance to the extent of debt financing, but not including the cost of finance to the extent of equity financing.

Since many entities use both debt and equity finance for their business activities, it seems inconsistent and conceptually unconvincing that the entity should trace the source of funding to determine the amount to be capitalised to a particular qualifying asset. Also, the fungible nature of cash means that pooled debt and equity funds can be difficult to apportion.

The AASB does not agree that qualifying assets should have different acquisition costs (and therefore carrying amounts) based on the financing adopted by the entity or simply based on difficulties associated with the apportionment of pooled funds. If capitalisation of only borrowing costs is allowed, the financing structure of an entity could affect the acquisition cost of an asset as well as its carrying amount. If an entity is debt-free, it could have a qualifying asset with a lower carrying amount compared to a debt-financed entity.

Further, the AASB notes that IPSAS 17 *Property, Plant and Equipment* (and IAS 16) explains the elements of cost in the context of property, plant and equipment and provides examples of directly attributable costs. IPSAS 17 seems to focus on the costs of "bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management" (see IPSAS 17.30 (b)). Borrowing costs are not specifically included as a directly attributable cost and the examples of directly attributable costs do not refer to borrowing costs. Consistent with the notion of cost underpinning

IPSAS 17 and the characteristic it is attempting to measure, the AASB does not believe that borrowing costs are relevant to the location, condition or operating capability of assets.

Although it could be argued conceptually that all financing costs (including borrowing costs) should be capitalised to qualifying assets, at a conceptual level, the AASB considers that borrowing costs are period costs and should be recognised immediately as an expense. This is because borrowing costs represent an element of the cost of financing the entity's collective activities for a period and represent the cost of the return due to the lender for the funds held by the entity for a certain period.

In summary, the AASB considers that ED 35 does not adequately justify the proposed modifications to IAS 23 based on the IPSASB's guidelines for modifying IFRSs, but that the IPSASB could potentially depart from IAS 23 based on conceptual grounds.

Yours sincerely,