IFRS 15 and IAS 23: Capitalization of Financing Costs

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The third step in the revenue model of IFRS 15 *Revenue from Contracts with Customers* is to determine the transaction price. Paragraph 60 of IFRS 15 requires entities to adjust the promised amount of consideration to reflect the time value of money for contracts with a significant financing component. This requirement applies to payments received both in advance and in arrears. When the payment is recognized in advance, the financing component is recognized as interest expense.

The Group discussed the following fact pattern and consider three issues related to the interest accrued on contract liabilities.

Fact Pattern

- Entity A constructs and sells an apartment unit to a customer. The customer pays the full consideration up front. Entity A concludes that revenue from apartment sales is recognized at a point in time upon delivery of the apartment, which is expected to be three years after the payment.
- The apartment unit is considered a qualifying asset under construction in accordance with paragraph 5 of IAS 23 *Borrowing Costs*.

Issue 1: Do borrowing costs include interest accrued on contract liabilities (i.e., such interest meets the definition of borrowing costs)?

In accordance with IFRS 15, Entity A needs to adjust the transaction price to reflect the financing provided by the customer and accrue interest on the contract liability.

View 1A – No, borrowing costs do not include interest accrued on contract liabilities.

Proponents of this view note that a contract liability is a non-monetary, non-financial liability, as it is settled with goods and services and not with cash or another financial instrument. The nature of the interest accrued on contract liabilities arising from advance payments is similar to interest expense that is recognized from unwinding a discount on decommissioning or restoration provisions. Such interest expense cannot be capitalized under IAS 23, according to paragraph 8 of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities.*

Proponents of this view also look to paragraph 6(a) of IAS 23 and think that to meet the definition of a borrowing cost, interest expense should be calculated using the effective interest method as described in IFRS 9 *Financial Instruments*. However, based on paragraph 64 of IFRS 15, the interest accrued on contract liabilities is calculated using a discount rate that reflects the credit characteristics of Entity A, or with reference to a cash alternative.

Another perspective is that the upfront payment from the customer is similar to a progress payment. Based on paragraph 18 of IAS 23, expenditures incurred on a qualifying asset are reduced by any progress payments received.

View 1B – Yes, borrowing costs include interest accrued on contract liabilities.

Proponents of this view think that the issue contemplated in IFRIC 1 is different from the fact pattern. Entity A is, in substance, borrowing cash from its customers instead of borrowing from a financial institution. Economically, the effect is the same as if Entity A borrowed cash from a bank and collected payments from the customer equivalent to the adjusted transaction price as the construction is completed. Under this arrangement, paragraph 8 of IAS 23 would require the capitalization of the interest expense on the borrowings as part of the cost of the qualifying asset.

Proponents of this view also note that paragraph 5 of IAS 23 defines borrowing costs as “interest and other costs that an entity incurs in connection with the borrowing of funds,” and paragraph 6(a) of IAS 23 indicates that borrowing costs “may” include interest expense calculated using the effective interest method as described in IFRS 9. Furthermore, interest accrued on contract liabilities may be calculated with reference to an entity’s borrowing rate based on paragraph 64 of IFRS 15, similar to lease liabilities that are mentioned in paragraph 6(d) of IAS 23.

In addition, given that there is a significant financing component when accounting for the customer payment received under IFRS 15, this upfront consideration is regarded as a borrowing rather than a progress payment.

The Group’s Discussion

Most Group members supported the view that borrowing costs include interest accrued on contract liabilities (i.e., View 1B). However, whether the amount is ultimately capitalized to the qualifying asset depends on the facts and circumstances because of the requirements in IAS 23 related to specific borrowings and general borrowings. One Group member noted that the IFRS Interpretations Committee recently discussed what the term “general borrowings” means and it will be important to monitor whether the final agenda decision has any implications for the determination of what is capitalized to the qualifying asset.[1]

A few Group members did not discount the view that borrowing costs exclude interest accrued on contract liabilities (i.e., View 1A). The thinking was that paragraph 65 of IFRS 15 indicates that the effects of financing are recognized as an interest expense. Also, when IFRS 15 was issued, IAS 23 was not amended, thereby suggesting that the financing component in the contract is not eligible for capitalization under IAS 23.

IFRS 15 requires entities to determine if there is a significant financing component in the contract. If there is a significant financing component, it is hard to ignore that there is a financing cost eligible for capitalization. Group members who supported View 1B thought that in the absence of any

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[1] Tentative agenda decision issued in June 2018. Refer to June 2018 IFRIC Update, “IAS 23 *Borrowing Costs* – Expenditures on a Qualifying Asset.”

consideration received upfront, the entity would have to borrow from a financial institution or issue shares to raise capital. At this point, the entity would analyze the requirements in IAS 23 to determine what amounts making up the financing cost should be capitalized.

Issue 2: Assume that interest accrued on contract liabilities meets the definition of borrowing costs (i.e., View 1B) and Entity A had previously elected to apply the borrowing costs exemption in IFRS 1* First-time Adoption of International Financial Reporting Standards. *Does the application of the borrowing cost exemption mean that Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively?

Entity A applied the exemption in paragraph D23 of IFRS 1 related to borrowing costs such that IAS 23 is applied prospectively from its date of transition to IFRS Standards (i.e., January 1, 2010). Assume that Entity A adopts IFRS 15 in 2018 and that the contract liability and significant financing component exists at the date of transition to IFRS Standards because the construction period is over 10 years.

IFRS 15 is applied retrospectively using either a fully retrospective method or with the cumulative effect of applying the standard recognized at the date of its initial application as an adjustment to the opening balance of retained earnings.

The question is whether Entity A's application of paragraph D23 of IFRS 1 fixes the starting point of applying IFRS Standards at Entity A's date of transition, or Entity A has to go back to the inception of the contract when applying IFRS 15 retrospectively.

View 2A – No, Entity A needs to go back to the inception of the contract when applying IFRS 15 retrospectively.

Proponents of this view think that the IFRS 1 exemptions are irrelevant for the application of a new accounting policy after the date of transition to IFRS Standards. The transition requirements under IFRS 15 do not set out special accommodations that would fix the starting point to the date of transition to IFRS Standards.

Another point to consider is that entities electing to apply the borrowing cost exemption did so on a voluntary basis at the date of transition. The adoption of IFRS 15 requirements, such as the recognition of a significant financing component on advance payments, should not allow an entity to retrospectively make IFRS 1 elections.

View 2B – Yes, Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively because IFRS 15 implicitly considers the transition requirements under IFRS 1.

Proponents of this view think IFRS 15 implicitly considers the requirements under IFRS 1 and fixes the starting point for the application of a new accounting policy to the date of transition to IFRS Standards. The rationale is that the carrying amounts of the assets and liabilities, and the elections made, when applying IFRS 1 become the basis for subsequent accounting under IFRS Standards.

Entity A would apply the transition requirements under IFRS 15 by taking into consideration its election of the borrowing costs exemption in paragraph D23 of IFRS 1. Entity A should be able to use the same prospective application when it applies the requirements of IAS 23 to interest accrued on its contract liabilities upon adopting IFRS 15.

View 2C – Entity A has an accounting policy choice.

Proponents of this view think that IFRS Standards are not specific on this point, and therefore, an accounting policy choice exists on the adoption of IFRS 15.

The Group's Discussion

Group members supported the view that Entity A does not have to go back to the inception of the contract when applying IFRS 15 retrospectively because IFRS 15 implicitly considers the transition requirements under IFRS 1 (i.e., View 2B).

A question was raised regarding what would happen if an entity transitioned to IFRS Standards but did not make a choice to apply the borrowing cost exemption because, at that time, the entity did not have any borrowing costs to account for under IAS 23. After a brief discussion, a few Group members thought that it may be possible for an entity to indicate that it would have elected to apply the borrowing cost exemption upon transition to apply the accounting under View 2B.

Issue 3: Assume that interest accrued on contract liabilities meets the definition of borrowing costs (i.e., View 1B). What is the effect of the amendments to IAS 23 that were issued in December 2017?

Analysis

The amendments to IAS 23 that were issued in December 2017 as part of the *Annual Improvements to IFRS Standards 2015-2017 Cycle* clarify that an entity treats as general borrowings any borrowings made specifically to obtain a qualifying asset that remain outstanding when the asset is ready for its intended use or sale. The amendments also clarify that funds borrowed specifically to obtain an asset other than a qualifying asset are included as part of the general borrowings pool. The amendments to IAS 23 are effective for annual reporting periods beginning on or after January 1, 2019, and are applied prospectively.

Assume Entity A recognizes revenue for the construction and sale of the apartment over time, and therefore, does not have an asset to which to capitalize borrowing costs. Entity A would need to include the contract liability, being the borrowings, in the general borrowings pool to determine the capitalization rate based on paragraph 14 of IAS 23.

The Group's Discussion

One Group member thought that it was important to first assess whether the borrowings in the fact pattern are considered specific borrowings under IAS 23. In addition, the views on this issue may be affected by the IFRS Interpretations Committee's recent discussion on whether an entity includes expenditures on a qualifying asset incurred before obtaining general borrowings in determining the amount of borrowing costs eligible for capitalization. Specifically, the IFRS Interpretations Committee discussed the fact that paragraph 14 of IAS 23 applies to the extent the entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset. It will be important to monitor whether the final agenda decision has any implications for the determination of what is capitalized to the qualifying asset.[2]

Another Group member offered a different perspective, noting that paragraph BC125 of the Basis for Conclusions on IFRS 15 states, in part, that "[i]n many typical service contracts, the entity's performance creates an asset only momentarily, because that asset is simultaneously received and consumed by the customer." This Group member contemplated whether this paragraph might influence the determination of whether a qualifying asset exists even if the asset was sold immediately after recognition. However, further consideration is required to think through the implications in this context.

Given the current discussions of the IFRS Interpretations Committee and the tentative agenda decision issued relating to IAS 23, the Group recommended monitoring the outcome of the international deliberations before determining whether further action is needed in this area.

(For a full understanding of the discussions and views expressed, listen to the audio clip).

[2] Tentative agenda decision issued in June 2018. Refer to June 2018 IFRIC Update, "IAS 23 *Borrowing Costs* – Expenditures on a Qualifying Asset."