# AS 18: BORROWING COST

Hello students, welcome to the Unit 2: Accounting Pronouncement. Today you will be studying AS 16 borrowing costs and this is your module #17.

During the course of this lecture you will be studying the scope of the standard, definition of terms, recognition of items of borrowing costs,illustration, borrowing, costs eligible for capitalization, the commencement suspension and cessation of capitalization of borrowing costs and disclosures.

After studying this unit, you will be able to identify qualifying and non qualifying assets and calculate interest that is to be capitalized and interest to be charged with the profit and loss account.

## SCOPE OF THE STANDARD

Now, this standard is applicable to accounting for borrowing costs. That is, if you've taken any kind of loan, iit will be applicable to that particular loan.
This does not apply to the cost of equity,including preference share capital. It also doesn't apply to those assets that are measured at fair value and also to inventories that are manufactured on a large scale repetitively.

## BORROWING COST

Borrowing costs are interests and other costs incurred by an enterprise in connection with the borrowing of funds.

## QUALIFYING ASSET

A qualifying asset Is that asset that takes a substantial period of time to get ready for its intended use or for its sale.
Now, examples of qualifying assets include manufacturing plants, factories, power generation facilities, investment properties, inventories, and so on.

## NON-QUALIFYING ASSET

Non-qualifying asset is one which is ready for use or sale at the time of its acquisition. So suppose if you purchase a machine, that machinery is already ready to be used and hence will not be a qualifying asset. Any working capital, purchase of technical know how are also examples of non-qualifying assets.

## SUBSTANTIAL PERIOD

Substantial Period means the time which an asset takes to be technologically and commercially ready for its intended use or sale. Now this depends upon each asset i.e. it depends upon the nature of each asset. A period of 12 months is usually considered as a substantial period or longer. Shorter periods can be justified depending upon the facts of the case.

**RECOGNITION OF BORROWING COSTS**

Borrowing costs are directly related to the acquisition, construction and production of qualifying assets should be capitalized. Borrowing costs directly related to the acquisition, construction, and production of non qualifying assets are to be treated as revenue expenditure.

Now look at this particular example. H Limited obtained a loan of 35 lakhs from a bank for the following purpose. The first one is to construct a manufacturing plant of Rupees 12.5 lakhs, purchase machinery of Rs. 10 lakhs and working Capital 7.5 lakhs and the advance for purchase of vehicle rupees 5 lakhs. In March 2020, the construction of the plant was completed and machinery was installed. The vehicle was delivered on 10th of April 2020.Total interest charged by the bank was Rupees 4,55,000. We are required to show the treatment of interest and the nature of assets. Now from this illustration we have to first classify which assets are qualifying assets and which assets are non qualifying assets.

- The first one that is construction of a manufacturing plant is a qualifying asset because it will take a substantial period of time to get ready for its sale or use.
- The purchase of machinery is a non qualifying asset because it is already available for use or sale.
- Working capital and the advance for purchase of vehicles are also non qualifying assets.

Now let us look at the solution to this illustration.

- So now we have to divide Rs. 4,55,000 interest among these four expenses, the first one that is the cost of construction of manufacturing plant costs Rupees 2.5 lakhs. So since this is a qualifying and asset, this interest will be capitalized. You always have to prepare a table showing the serial number, particulars nature of the asset, interest to be capitalized, if that asset is a qualifying asset and interest to be charged to the profit and loss account. The total interest of Rs. 4,55,000 will be multiplied by the amount spent on construction of the plant that is. Rs. 12.5 lakhs divided by the total amount of the loan, that is Rs. 35 lakhs. So Rs. 1,62,500 will be capitalized.
- Now the rest of the assets, that is machinery, working capital, and advance are all non qualifying assets. So all these will appear or all the interest on all of this will be charged to the profit and loss account.
- Now to calculate the interest to be charged Rs. 4,55,000 will be multiplied by Rs. 10 lakhs. That is a purchase price of machinery divided by Rs. 35 lakhs i.e. the total value of the loan taken. Similar calculations will be there for working capital and advance for purchase of vehicle . All this interest will be charged as expense in the profit and loss account. So interest on qualifying asset costs is to be capitalized and interest or non qualifying assets are charged to the profit and loss account. Boring cost eligible for capitalization.

**TYPES OF BORROWINGS**

There are two types of borrowings: we have specific borrowings and general borrowings.

A. When you obtain funds specifically for a certain purpose, it is called specific borrowing. In such a case, the amount to be capitalized will be the actual borrowing costs incurred minus any income on temporary investment. Now, sometimes the funds that you receive will be invested temporarily in order to earn some kind of interest. So the interest that you earn on this investment will be minused from the borrowing cost incurred.
B. The next type of borrowing is the general borrowing. The funds that are borrowed for a general purpose. The amount to be capitalized is equal to capitalization rate multiplied by the amount spent on the qualifying asset divided by the total amount of loan. Now, capitalization rate is the weighted average of borrowing costs. Now the borrowing costs to be capitalized should not be more than the borrowing cost incurred.

**COMMENCEMENT OF CAPITALIZATION OF BORROWING COST**

There are certain preconditions that need to be satisfied for the capitalization of borrowing costs to commence:

1. when an expenditure for the acquisition, construction, or production of a qualifying asset is incurred.
2. borrowing costs are being incurred and the
3. activities that are necessary to prepare the asset for its intended use or sale are in progress.

So when these three conditions are satisfied on that particular date, the borrowing costs will commence.

**CESSATION OF CAPITALIZATION OF BORROWING COST**

The capitalization of borrowing cost stops during extended periods, if the active development of that asset is interrupted. That time, the capitalization of borrowing costs are suspended.

Borrowing costs are not suspended when substantial technical, and administrative work is being carried out or the delay is a part of getting an asset ready for its intended use or sale. This is especially true when you are producing alcohol or the nature of your business is alcohol, so they need a certain time of maturity in order to get them ready for sale. So in that case, it will not be considered as suspension.

Capitalization of borrowing costs stops when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

**DISCLOSURES**

The financial statement should disclose

1. the amount of borrowing costs capitalized during the period and
2. The capitalization rate used to determine the amount of borrowing costs eligible for capitalization.

These are my references. Thank you.