IPSAS 5 Borrowing Costs – as adopted by the Maltese Government

Guidelines

IPSAS Implementation Team

MARCH 2019

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Introduction

1. IPSAS 5 Borrowing Costs – as adopted by the Maltese Government

1.1 These guidelines refer to the Borrowing Costs accounting standard **as adopted by the Maltese Government**. This version is based on the original IPSAS 5 developed by the International Public Sector Accounting Standards Board (IPSASB). Modifications were made to the original standard to make it more applicable to the local context. A summary of the differences with the original IPSAS 5 can be found as an Appendix to the standard, entitled **Comparison with IPSAS 5**.

2. Scope

2.1 These guidelines were prepared to enable the users to:

2.1.1 Develop a working-level knowledge of the principles contained in the accounting standard; and

2.1.2 Understand and appreciate the major challenges and benefits resulting from the implementation of IPSAS 5[1].

3. Target Audience

3.1 These guidelines are designed for finance and non-finance employees employed in Ministries and Departments of the Government of Malta.

4. Guidelines Structure

4.1 These guidelines shall provide a detailed overview of all the principles contained in the standard, focussed on the accounting treatment of borrowing costs.

[1] References to IPSAS 5 or any other IPSAS shall be taken as meaning 'as adopted by the Maltese Government'.

A. Borrowing Costs Defined

1. Borrowing costs are interest and other expenses incurred by an entity.

2. Borrowing costs may include:

- Interest on bank overdrafts and short-term and long-term borrowings;
- Amortization of discounts or premiums relating to borrowings;
- Amortization of ancillary costs incurred in connection with the arrangement of borrowings;
- Finance charges in respect of finance leases; and
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

B. Impact of IPSAS 5 Implementation

1. One of the major differences between the ***current cash-based accounting system*** and ***accruals-based accounting*** is that in the cash-based system Borrowing Costs are expensed when there is a cash outlay.

2. For many Central Government entities, this standard will not be applicable, as most of the borrowing in Central Government is centralised at the Treasury. However, this guideline is still being presented to offer guidance on the treatment of borrowing costs where it is applicable.

C. Borrowing Costs—Benchmark Treatment

IPSAS 5 Borrowing costs should be recognised as an expense in the period in which they are incurred.

1. Under the benchmark treatment, borrowing costs are recognised as an expense in the period in which they are incurred, regardless of how the borrowings are applied.
2. The financial statements should disclose the accounting policy adopted for borrowing costs.

D. Borrowing Costs—Allowed Alternative Treatment

> Borrowing costs that are **directly attributable** to the acquisition, construction or production of a **qualifying asset** should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard.

1. A **Qualifying asset** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

2. Examples of **qualifying assets** are office buildings, hospitals, infrastructure assets such as roads, bridges and power generation facilities, and inventories that require a substantial period of time to bring them to a condition ready for use or sale. Other investments, and those assets that are routinely produced over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are also not qualifying assets.

3. Under the allowed alternative treatment, borrowing costs that are **directly attributable** to the acquisition, construction or production of an 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 or service potential to the entity and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

4. Where an entity adopts the **allowed alternative treatment**, that treatment should be applied **consistently to all borrowing costs** that are directly attributable to the acquisition, construction or production of all qualifying assets of the entity.

5. Borrowing Costs Eligible for Capitalisation:

5.1 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 outlays on the qualifying asset had not been made.

5.2 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.

5.3 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 co-ordinated centrally.

5.4 To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the **actual borrowing costs** incurred on that borrowing during the period **less any investment income** on the temporary investment of those borrowings.

5.5 When funds are borrowed **generally**, borrowing costs shall not be capitalised. In this case the **benchmark treatment shall apply**, and borrowing costs are recognised as an expense in the period in which they are incurred. This effectively also means that no capitalisation rate shall be used to capitalise borrowing costs for funds borrowed generally.

5.6 When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realizable value, the carrying amount is written down or written off in accordance with the requirements of other accounting standards.

> Ministries and Departments shall not apply the allowed alternative treatment unless funds are being borrowed **specifically** for the purpose of obtaining a **qualifying asset** and the **borrowing costs** directly relating to that qualifying asset can be readily identified. Funds borrowed **generally** shall **not** be capitalised.

6. **Commencement of Capitalisation**: The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when:
   6.1 Outlays for the asset are being incurred;
   6.2 Borrowing costs are being incurred; and
   6.3 Activities that are necessary to prepare the asset for its intended use or sale are in progress.

7. **Suspension of Capitalisation**: Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted, and expensed.
   7.1 Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended
      7.1.1. During a period when substantial technical and administrative work is being carried out.
      7.1.2. Capitalisation of borrowing costs is also not suspended 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 an extended period needed for inventories to mature or an extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

8. **Cessation of Capitalisation**: Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.
   8.1 When the construction of a qualifying asset is completed in parts and each part is capable of being used while construction continues on other parts, capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed.
   8.2 Examples of qualifying assets that need to be complete before any part can be used include an operating theatre in a hospital when all construction must be complete before the theatre may be used and a sewage treatment plant where several processes are carried out in sequence at different parts of the plant.

E. Disclosure & Examples

1. **Disclosure**: The financial statements should disclose:
   1.1 The accounting policy adopted for borrowing costs;
   1.2 The amount of borrowing costs capitalized during the period.

2. **Examples**
   2.1 Department A borrowed €10m from First Bank for a period of one year to finance the acquisition of a qualifying asset costing a total of €10m. The borrowing interest rate is at 5%. Before the commencement of operations, Department A invested the borrowings in a short term investment for 6 months yielding 2% interest.

   The amount of borrowing costs that can be capitalised in the above example is (€10m X 5%) – (€10m X (6/12 X 2%) = **€400,000**

   2.2 Department Z borrowed €15m for a term of one year, exclusively to finance the construction of a block of offices.
   The interest rate on the loan is 5% and is payable on maturity of the loan.
   The loan was borrowed on 1st February 2017 and the construction commenced on 1st April 2017. Unfortunately no construction took place between 1st May 2017 to 31st August 2017, however construction was then resumed - asset was completed and ready for use on 31st December 2017. Construction cost was €15m.
   What is the carrying amount of the office block in Department Z's statement of financial position as at 31st December 2017?

   Commencement of Construction 1/4/2017 – 30/4/2017 = 1 month
   Continuation of Construction 1/9/2017 – 31/12/2017 = 4 months
   Carrying Amount = €15m + borrowing costs (€15m X 5% X 5/12) = **€15,312,500**

Glossary

''Accruals-based accounting'' Accruals-based accounting is a system of accounting based on the accrual principal, under which revenue is recognised (recorded) when earned, and expenses are recognised when incurred.

''Asset'' An asset is a resource presently controlled by the entity as a result of a past event and from which future economic benefits or service potential are expected to flow to the entity.

'Borrowing Costs'' Borrowing costs are interest and other expenses incurred by an entity in connection with the borrowing of funds.

''Central Government Entities (CGEs)'' The term CGEs refers only to ministries and departments of the Government of Malta.

'Qualifying asset'' Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.