UNIT 4: ACCOUNTING STANDARD 16 BORROWING COSTS

LEARNING OUTCOMES

After studying this unit, you will be able to recognize–

- Meaning of Borrowing costs;
- Definition of Qualifying Asset;
- Accounting treatment for borrowings – Specific and general borrowings;
- Time when does Commencement of Capitalisation takes place;
- Time when does Suspension and cessation of Capitalisation takes place;
- Disclosure requirements for this standard.

4.1 INTRODUCTION

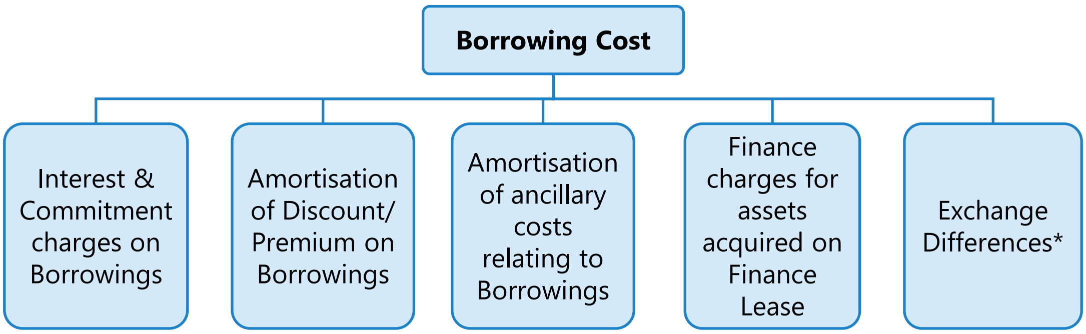
The objective of AS 16 is to prescribe the accounting treatment for borrowing costs. It does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Clarification Chart:

Particulars	Remarks – Is the fund covered by AS 16?
Equity share capital	No
Retained earnings	No
Preference Share Capital classified as a liability	Yes
Preference Share Capital classified as equity	No

4.2 DEFINITIONS

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



*To the extent they are regarded as an adjustment to interest cost

A *qualifying asset* is an asset (Tangible or intangible) that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Clarification Chart:

Particulars	**Is it a qualifying asset?**
PPE (Property, plant and equipment)	Yes
Intangible assets	Yes
Investment Properties	Yes
(Building meant for capital appreciation and earning rental income)	

Inventory	Yes – If they require a substantial period of time to bring them to a saleable condition.
Investments (Financial assets)	No

Accounting standard further clarifies the meaning of the expression 'substantial period of time'. According to it, substantial period of time primarily depends on the facts and circumstances of each case. It further states that, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case. Therefore, a rebuttable presumption of a period of twelve months is considered "substantial" period of time. In estimating the period, time which an asset takes technologically and commercially to get it ready for its intended use or sale should be considered.

4.3 EXCHANGE DIFFERENCES ON FOREIGN CURRENCY BORROWINGS

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, 'The Effect of Changes in Foreign Exchange Rates'. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

Clarification Chart:

Particulars	Accounting Treatment
Exchange Gain	Credited to P&L

Exchange Loss	**Lower** of the following is treated as a part of borrowing costs: 1. Actual exchange loss; 2. Difference between interest on local currency borrowings and interest on foreign currency borrowings. **Note:** The excess exchange difference if any will be charged to P&L A/c.

If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16.

If there is exchange gain in the next year, then it will reduce the borrowing cost in that year to the extent exchange loss was earlier treated as borrowing cost for that borrowing.

Example

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X1, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X1, the exchange rate between the currencies was ₹ 45 per USD. The exchange rate, as at March 31, 20X2, is ₹ 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X1.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

(i) Interest for the period = USD 10,000 x 5% x ₹ 48/USD = ₹ 24,000

(ii) Increase in the liability towards the principal amount = USD 10,000 x (48-45) = ₹ 30,000

(iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 x 45 x 11% = ₹ 49,500

(iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 49,500 – ₹ 24,000 = ₹ 25,500

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to *the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500.*

Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e., ₹ 34,500 (₹ 58,500 – ₹ 24,000)] is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11 'The Effects of Changes in Foreign Exchange Rates'.

4.4 BORROWING COSTS ELIGIBLE FOR CAPITALISATION

Treatment of Borrowing Costs

Borrowing Costs

Directly related* for
* acquisition
* construction
* production of

Qualifying Assets	Assets other than Qualifying assets
Capitalized	Revenue Expenditure

*or that could have been avoided if the expenditure on qualifying assets had not been made.

The borrowing costs (including exchange loss treated as borrowing cost as per para 4(e)) 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. Other borrowing costs are recognised as an expense in the period in which they are incurred.

4.5 RECOGNITION CRITERIA

Borrowing costs are capitalised as part of the cost of a qualifying asset when:

(a) it is probable that they will result in future economic benefits to the enterprise; and

(b) the costs can be measured reliably.

Borrowing costs

- Specific borrowings
- General borrowings

Illustration 1

PRM Ltd. obtained a loan from a bank for ₹ 120 lakhs on 30-04-20X1. It was utilised as follows:

Particulars	***Amount (₹ in lakhs)***
Construction of a shed	*50*
Purchase of a machinery	*40*
Working Capital	*20*
Advance for purchase of truck	*10*

Construction of shed was completed in March 20X2. The machinery was installed on the date of acquisition. Delivery of truck was not received. Total interest charged by the bank for the year ending 31-03-20X2 was ₹ 18 lakhs. Show the treatment of interest.

Solution

Qualifying Asset as per AS 16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalised = 18 x 50/120 = ₹ 7.5 lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs = ₹ 10.5 lakhs

4.6 SPECIFIC BORROWINGS

When an enterprise 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.

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 income on the temporary investment of those borrowings.

Amount eligible for capitalisation:

= Actual borrowing costs incurred (-) Any income on the temporary investment of those borrowings

The financing arrangements for a qualifying asset may result in an enterprise obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure 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 income earned on the temporary investment of those borrowings is deducted from the borrowing costs incurred.

4.7 GENERAL BORROWINGS

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. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

Step 1 - Compute the capitalisation rate:

Where,

$$\text{Capitalization Rate} = \frac{\text{Borrowing cost on general borrowings}}{\text{Weighted average of general borrowings outstanding during the period}} \times 100$$

Step 2 - Amount eligible for capitalisation:

= Expenditure incurred on Qualifying asset x Capitalisation rate

Step 3 – Cross check:

The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

4.8 EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE 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 Accounting Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Accounting Standards.

Illustration 2

X Ltd. began construction of a new building on 1st January, 20X1. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 20X1 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	*Rate of Interest*
₹ 5,00,000	*11%*
₹ 9,00,000	*13%*

The expenditures that were made on the building project were as follows:

		₹
January	*20X1*	*2,00,000*
April	*20X1*	*2,50,000*
July	*20X1*	*4,50,000*
December	*20X1*	*1,20,000*

Building was completed by 31[st] *December 20X1. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.*

Solution

(i) Computation of weighted average accumulated expenses

		₹
₹ 2,00,000 x 12 / 12	=	2,00,000
₹ 2,50,000 x 9 / 12	=	1,87,500
₹ 4,50,000 x 6 / 12	=	2,25,000
₹ 1,20,000 x 1 / 12	=	10,000
		6,22,500

(ii) Calculation of weighted average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest		Amount of interest (₹)
5,00,000	11%	=	55,000
9,00,000	13%	=	1,17,000
14,00,000			1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000} \times 100\right)$		=	12.285% (approx.)

(iii) Interest on weighted average accumulated expenses

		₹
Specific borrowings (₹ 1,00,000 x 10%)	=	10,000
Non-specific borrowings (₹ 5,22,500* x 12.285%)	=	64,189
Amount of interest to be capitalised	=	74,189

(iv) Total expenses to be capitalized for building

	₹
Cost of building ₹ (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

(v) Journal Entry

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12. 20X1	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalised)			

4.9 COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when **all** the following conditions are satisfied:

a. **Expenditure for the acquisition, construction or production of a qualifying asset is being incurred**: Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash,

* (₹ 6,22,500 – ₹ 1,00,000)

transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. Borrowing costs are being incurred.

c. **Activities that are necessary to prepare the asset for its intended use or sale are in progress**: The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of 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. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

4.10 SUSPENSION OF CAPITALISATION

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

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 during a period when substantial technical and administrative work is being carried out.

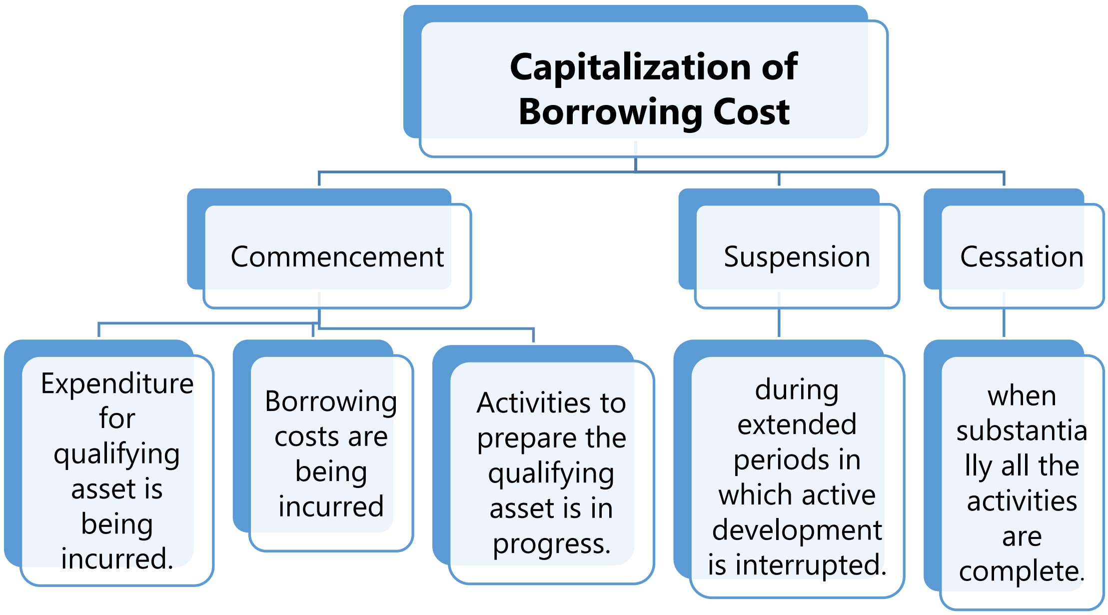
Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example: capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

4.11 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.

An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete. 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 used while construction continues for the other parts. An example of a qualifying asset that needs to be complete 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.



4.12 DISCLOSURE

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

b. The amount of borrowing costs capitalised during the period.

Illustration 3

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31st March, 20X2 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 20X1-20X2 on the entire Institutional Term Loan of ₹ 580 lakhs.

Solution

As per para 6 of AS 16 'Borrowing Costs', 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. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

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

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

Purpose	Nature	Interest to be capitalised	Interest to be charged to profit and loss account
		₹ in lakhs	₹ in lakhs
Modernisation and renovation of plant and machinery	Qualifying asset	$**52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	$**52.20 \times \frac{58}{580} = 5.22$	
Working Capital	Not a qualifying asset		$52.20 \times \frac{116}{580} = 10.44$
		41.76	10.44

** A substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case.*

*** It is assumed in the above solution that the modernisation and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and* *machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31st March, 20X2.*

Illustration 4

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 20X1-20X2. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs. As on 31st March, 20X2, since the said project was not complete, the directors of Take Ltd. resolved to capitalise the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

Solution

As per AS 13 (Revised) "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 20X2.

Reference: The students are advised to refer the full text of AS 16 "Borrowing Costs" (issued 2000).

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *As per AS 16, all the following are qualifying assets except*

   (a) Manufacturing plants and Power generation facilities

   (b) Inventories that require substantial period of time

   (c) Assets those are ready for sale.

   (d) None of the above

2. *Which of the following statement is correct:*

   (a) Entire exchange gain is reduced from the cost of the Qualifying asset.

   (b) Entire exchange loss is added to the cost of a Qualifying asset.

   (c) No adjustment is done for the exchange loss while computing cost of Qualifying asset.

   (d) None of the above

3. *Capitalisation rate considers:*

   (a) Borrowing costs on general borrowings only.

   (b) Borrowing costs on general and specific borrowings both.

   (c) Borrowing costs on specific borrowings only

   (d) None of the above

4. *If the amount eligible for capitalisation in case of inventory as per AS 16 is ₹ 12,000 and cost of inventory is ₹ 40,000 and its net realizable value is ₹ 45,000; What amount can be capitalised as a part of inventory cost.*

   (a) ₹ 12,000.

   (b) ₹ 5,000.

   (c) ₹ 7,000.

   (c) ₹ 10,000.

5. *X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:*

   (i) *15th May, 20X1: Loan interest relating to the project starts to be incurred*

   (ii) *2nd June, 20X1: Technical site planning commences*

   (iii) *19th June, 20X1: Expenditure on the project started to be incurred*

   (iv) *18th July, 20X1: Construction work commences*

   Identify the commencement date for capitalisation under AS 16.

   (a) *15th May, 20X1.*

   (b) *19th June, 20X1.*

   (c) *18th July, 20X1.*

   (d) *2nd June, 20X1*

Theoretical Questions

6. *When capitalization of borrowing cost should cease as per Accounting Standard 16? Explain the provision.*

7. *H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 20X1. However, decoration work is under process which is expected to be completed by November 20X1 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 20X1.*

8. *ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for the whole park until construction continues?*

Scenario based Questions

9. *On 1st April, 20X1, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilised as under:*

(i)	*Construction of sealink across two cities: (work was held up totally for a month during the year due to high water levels)*	:	*₹ 25 crores*
(ii)	*Purchase of equipments and machineries*	:	*₹ 3 crores*
(iii)	*Working capital*	:	*₹ 2 crores*
(iv)	*Purchase of vehicles*	:	*₹ 50,00,000*
(v)	*Advance for tools/cranes etc.*	:	*₹ 50,00,000*
(vi)	*Purchase of technical know-how*	:	*₹ 1 crores*
(vii)	*Total interest charged by the bank for the year ending 31st March, 20X2*	:	*₹ 80,00,000*

Show the treatment of interest by Amazing Construction Ltd.

10. *Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.20X1 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.20X2. Due to surplus fund out of ₹ 150 crores, income of ₹ 3.50 crores were earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.*

11. *Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.*

Following is the detail of the work done on different phases of the building during the current year:

(₹ in lakhs)

	Phase I ***₹***	***Phase II*** ***₹***	***Phase III*** ***₹***	***Phase IV*** ***₹***
Cash expenditure	*10*	*30*	*25*	*30*
Building purchased	*24*	*34*	*30*	*38*
Total expenditure	*34*	*64*	*55*	*68*
Total expenditure of all phases				*221*
Loan taken @ 15% at the beginning of the year				*200*

During mid of the current year, Phase I and Phase II have become operational.

Find out the total amount to be capitalized and to be expensed during the year.

12. *Expert Limited issued 12% secured debentures of ₹ 100 lakhs on 01.06.20X1. Money raised from debentures to be utilized as under:*

Intended Purpose	**Amount ₹ in lakhs**
Construction of factory building	40
Working Capital	30
Purchase of Machinery	15
Purchase of Furniture	2
Purchase of truck	13

Additional Information:

(i) Interest on debentures for the Financial Year 20X1-20X2 was paid by the Company.

(ii) During the year, the company invested idle fund of ₹ 5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of ₹ 50,000.

(iii) In March, 20X2 construction of factory building was not completed (it is expected that it will take another 6 months).

(iv) In March 20X2, Machinery was installed and ready for its intended use.

(v) Furniture was put to use at the end of March 20X2.

(vi) Truck is going to be received in April, 20X2.

You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 20X2 in the Books of Expert Limited.

ANSWERS/SOLUTIONS

Answer to the Multiple Choice Questions

1.	(c)	**2.**	(d)	**3.**	(a)	**4.**	(b)	**5.**	(b)

Answer to the Theoretical Questions

6. Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete. When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

7. The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 20X1. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 20X1. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 20X1.

8. ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project.

Answer to the Scenario based Questions

9. According to AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

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. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	**Interest to be capitalised ₹**	**Interest to be charged to Profit & Loss A/c ₹**	
Construction of sea-link	Yes	62,50,000		[80,00,000x(25/32)]
Purchase of	No		7,50,000	[80,00,000x(3/32)]

equipment and machineries				
Working capital	No		5,00,000	[80,00,000x(2/32)]
Purchase of vehicles	No		1,25,000	[80,00,000x(0.5/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000x(0.5/32)]
Purchase of technical know-how	No		2,50,000	[80,00,000x(1/32)]
Total		62,50,000	17,50,000	

*It is assumed that work held up for a month due to high water level is normal during the construction of sealink and capitalization of borrowing cost should not be suspended for necessary temporary delay.

10. Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Thus, the treatment of accountant of Rainbow Ltd. is incorrect.

Amount of borrowing costs capitalized should be calculated as follows:

Particulars	**₹ in crores**
Actual interest for 20X1-20X2 (11% of ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 20X1-20X2	13.00

11. Computation of amount to be capitalized

No.	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2.	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate $\text{Loan amount} = \frac{30,00,000}{2,21,00,000} \times 98,00,000$	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on $\text{proportionate Loan amount} = \frac{30,00,000}{2,21,00,000} \times 1,23,00,000$	16,69,683 (approx.)

Accounting treatment

For Phase I and Phase II

Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

For Phase III and Phase IV

Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

12. According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = ₹ 10,00,000 (100 lakhs x 12% x 10/12) – ₹ 50,000 = ₹ 9,50,000

Particulars	**Nature of assets**	**Interest to be capitalized (₹)**	**Interest to be charged to Profit & Loss Account (₹)**
Construction of factory building	Qualifying Asset	9,50,000x40/100 = ₹ 3,80,000	NIL
Purchase of Machinery	Not a Qualifying Asset	NIL	9,50,000x15/100 = 1,42,500
Purchase of and furniture	Not a Qualifying Asset	NIL	9,50,000x2/100 =19,000
Purchase of truck	Not a Qualifying Asset	NIL	9,50,000x13/100 = 1,23,500
Working Capital	Not a Qualifying Asset	NIL	9,50,000x30/100 = ₹ 2,85,000
Total		₹ 3,80,000	₹ 5,70,000