

## Choice of Accounting Policies on Borrowing Cost in View on IAS 23 “Borrowing Costs”

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### Abstract

*The phenomenon of globalization has generated in national accounts, processes such as harmonization, convergence and accounting normalization precisely in order to achieve a common language regarding the presentation of the annual financial statements of the companies. In Romania, taking over the international referential has been achieved gradually, the process is still ongoing. Under these circumstances, the present research aims to go through the international referential regarding the borrowing costs of fixed assets and to establish, where appropriate, the elements taken over by the Romanian regulatory in the national accounting practice.*

**Key words:** Borrowing costs, the qualifying assets, the capitalization process, general borrowings, special borrowings.

**J.E.L. classification:** M41

### 1. Introduction

The most relevant options of accounting policies with effects on the recognition value of fixed assets are: *the choice between one or another depreciation method, the establishment of the amortizable value* known as the fact that the Romanian practice does not recognize the residual value, *the model of the useful life* – is free in for the international referential version, respectively is normalized in Romanian version, *the option between keeping the historical cost or revaluing fixed assets*, for instance, *treating the borrowing cost* directly attributable to the realization of a long-term asset between capitalization and its recognition as an expense. Due to the fact that the consequences of capitalizing interest directly attributable to the realization of a long-term asset have implications not only on the measure of that asset and its depreciable amount, but may also lead to reshaping of the useful life and the depreciation method, we have proposed to gradually review the accounting treatment applicable to borrowing costs under IAS 23 "Borrowing Costs".

### 2. Theoretical background

International reference IAS 23 is addressed to the issue of interest costs that can be incorporated into the value of long-run assets. Incorporation of these costs is conditioned by their direct attribution to the asset, otherwise they will affect the cost of the period. The beginning of the capitalization period implies fulfilling three conditions, as follows: a) expenditure on the asset is carried out; b) borrowing costs are generated; c) the activities necessary for the realization of the asset have been started. Asset realization activities involve more than the physical construction of the asset, for example, obtaining building permits prior to the actual start of the building works.

The capitalization method differs as borrowed funds are of a general nature or, on the contrary, contracted specifically for the realization of the long-run asset. The interest that will be capitalized in the case of general loans is obtained by applying a capitalization rate to the costs generated by obtaining the asset. The capitalization rate is *“the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than*

*borrowings made specifically for the purpose of obtaining a qualifying asset*" (IAS 23, paragraph 14).

For loans specifically contracted to finance long-term assets, capitalized interest is obtained as the difference between interest costs over the life of the asset and any income arising from the placement of surplus lent and unused funds at a time t.

According to IAS, interest costs are suspended during long periods of discontinuation and capitalization ceases when most of the costs of bringing the asset to the state of use or sale have been made.

The Romanian normalizer, through OMFP no. 1.802/2014, takes over Article 80, the concepts and techniques of IAS 23 "Borrowing Costs". It is mentioned in Article 80, paragraph (3) "*a long-term asset is the one that necessarily requires a substantial period of time to be ready for its intended use or for sale*". It also states that "*the borrowing costs attributable to long-run assets are included in their production costs to the extent that they relate to the production period. Borrowing costs include interest on borrowed capital to finance the acquisition, construction or production of long-cycle assets*" (Article 80, paragraph 1). However, as no distinction is made between funds lent specifically for financing long-term assets and those borrowed in a general manner but used to obtain assets, we will approach within this article the treatment of interest expenses in vision of IAS 23, "Borrowing Costs".

### 3. Methodology

*The research is an explanatory one and seeks to capture the current situation in international accounting with regard to the treatment of interest costs. Attempting to highlight the similarities found between the international and the Romanian reference in force - OMFP no. 1.802/2014, it can be admitted that the research is also a comparative one.*

### 4. Findings

To capture the treatment applicable to borrowing costs in IAS 23, we present the following case studies:

*Example no. 1:* A company has made the following special loans to finance the construction of a building in period 2017 – 2018:

- ✓ 250.000 lei in previous period with an interest rate of 9%;
- ✓ in 01.04.2017 the construction of the building started and from the previous loan 90.000 lei were not reimbursed;
- ✓ in 01.09.2017 first invoice issued by the builder of 90.000 lei is paid;
- ✓ in 01.01.2018 a bank loan is also contracted, in the amount of 170.000 lei with an interest rate of 8% per year. The amounts is not used immediately and was recorded in a bank deposit with an interest rate of 5.2% per year;
- ✓ at 01.03.2018 an invoice of 100.000 lei is paid from bank deposit;
- ✓ in 01.10.2018 another invoice of 60.000 lei is paid and building period is suspended for 4 month. After this period the building activity starts again and construction of the hall is finished.

You are required to highlight in the accounting the records relating to year 2017 and 2018.

*Solution:*

*A. Accounting records for 2017*

Capitalization of interest costs for the period 01.09.2017 - 31.12.2017 (the capitalization starts when the expenses for the respective asset are covered, for instance when the first invoice is paid).

Borrowing costs are calculated for the part of the outstanding loan:

90.000 lei x 9% x 4/12 = 2.700 lei

1.1) Recognition for the interest expenses

|                  |   |                                  |       |
|------------------|---|----------------------------------|-------|
| 666              | = | 1682                             | 2.700 |
| Interest charges |   | Interest on long term bank loans |       |

|  |   |   |       |
|--|---|---|-------|
| 1.2) Capitalization of borrowing costs |   |   |       |
| 231                                    | = | 722   | 2.700 |
| Tangible fixed assets in progress      |   | Income from production of tangible fixed assets |       |

1.3) Expenses recognition for the months prior to the first payment (01.01.2017 – 31.08.2017)

|                                    |   |                                 |       |
|------------------------------------|---|---------------------------------|-------|
| 90.000 lei x 9% x 8/12 = 5.400 lei |   |                                 |       |
| 666                                | = | 1682                            | 5.400 |
| Interest charges                   |   | Interest on long term bank loan |       |

*B. Accounting records for year 2018*

1) Recording the new loan

|                      |   |                      |         |
|----------------------|---|----------------------|---------|
| 5121                 | = | 1621                 | 170.000 |
| Bank accounts in lei |   | Long term bank loans |         |

2) Deposit's creation

|                    |   |               |         |
|--------------------|---|---------------|---------|
| 2678               | = | 5121          | 170.000 |
| Other fixed trades |   | Bank accounts |         |

3) Capitalization of interest costs for a period of 01.01.2018–30.09.2018 (capitalization ceases during periods of activity interruption)

Cost capitalization for old loans:  $90.000 \times 9\% \times 9/12 = 6.075$  lei

Cost capitalization for new loan:  $170.000 \times 8\% \times 9/12 = 10.200$  lei

Total capitalization cost  $6.291 + 10.200 = 16.275$  lei

3.1) Recognition of borrowing costs

|                  |   |                                 |        |
|------------------|---|---------------------------------|--------|
| 666              | = | 1682                            | 16.275 |
| Interest charges |   | Interest on long term bank loan |        |

3.2.) Capitalization of interest costs

|                                   |   |   |        |
|-----------------------------------|---|---|--------|
| 231                               | = | 722   | 16.275 |
| Tangible fixed assets in progress |   | Income from production of tangible fixed assets |        |

4) Reduction the borrowing costs with interest income on bank deposit

Interest income for 01.01.2018 – 01.03.2018  $170.000 \times 5,2\% \times 2/12 = 1.473$

Interest income for 01.03.2018 – 30.09.2018  $(170.000 - 100.000) \times 5,2\% \times 7/12 = 2.123$

Total interest during capitalization period  $1.473 + 2.123 = 3.596$  lei

4.1) Recognition of income interests

|   |   |                 |       |
|---|---|-----------------|-------|
| 2679                                      | = | 766             | 3.596 |
| Interests on other non-current receivable |   | Interest income |       |

4.2) Reducing of capitalized borrowing costs

|  |   |   |         |
|--|---|---|---------|
| 231                                      | = | 722   | (3.596) |
| Tangible fixed assets under construction |   | Income from production of tangible fixed assets |         |

5) Expenses recognition in the period 01.10.2018–31.12.2018

Old loan:  $90.000 \text{ lei} \times 9\% \times 3/12 = 2.025$  lei

New loan:  $170.000 \text{ lei} \times 8\% \times 3/12 = 3.400$  lei

Total costs recognition of the charges for this period  $2.025 + 3.400 = 5.425$  lei

|                  |   |                             |       |
|------------------|---|-----------------------------|-------|
| 666              | = | 1682                        | 5.425 |
| Interest charges |   | Interest on long term loans |       |

*Example no. 2:* At the beginning of 2018 S.C. Alfa S.A. has made the following general loans:

- a) long-term bank loan of 350,000 lei with an interest rate of 8% for the construction of a building;
- b) a bank loan amounting to 190.000 lei with an interest rate of 8% for the construction of a production hall;
- c) a bank loan in the amount of 80.000 lei with an interest rate of 7% for the construction of a production hall.

S.C. Alfa S.A. uses the sum of 160.000 lei for the construction of the production hall on February 1st, 2018, and the amount of 70.000 lei on September 1<sup>st</sup>, 2018. What are the interest costs that will be capitalized for the construction of the production hall?

*Solution:*

As the loan of 350.000 lei having an interest of 8% concerns the construction of another asset than the production hall, it will not enter into our sphere of interest.

The capitalization rate for the other 2 loans is calculated as follows:

$$190.000 \times 8\% / (190.000 + 80.000) + 80.000 \times 7\% / (190.000 + 80.000) = 5,629\% + 2,074\% = 7,70\%$$

The capitalized interest costs for the construction of the production hall:

$$160.000 \times 7,70\% \times 11/12 + 70.000 \times 7,70\% \times 4/12 = 11.293 \text{ lei} + 1.797 \text{ lei} = 13.090 \text{ lei}$$

## 5. Conclusions

The international reference addresses differently to the interest costs capitalized with the value of long-cycle assets. If for loans specifically contracted to finance such assets the interests that can be capitalized are obtained as a difference between the current interest costs and the incomes obtained from the placement of the unused amounts in bank deposits, for the general loans the interests included in the value of the assets are obtained by applying the rate of capitalization of credit amounts used.

Although the Romanian reference has taken over some of the international concepts and techniques regarding the borrowing costs – defining long-term assets and specifying when the interest capitalization should cease (Article 80 paragraphs 1-6 of OMFP no.1802/2014), as nothing is said about the capitalization of interest in the two situations – by resorting to special loans for the construction of assets or, on the contrary, to general loans, and here different practices of calculating the capitalized interest, we will consider that the only similarities between the two referential are just those mentioned above.

## 6. References

- IAS 23 „Borrowing costs”, Annual Improvements to IFRS Standards 2015 – 2017 Cycle;
- OMFP no. 1802/2014 for the approval of the Accounting Regulations on the individual annual financial statements and the consolidated annual financial statements, Official Gazette no. 963/2014.