Educational material 4

APPLICATION OF IFRS STANDARDS IN LIGHT OF THE CORONAVIRUS DISEASE (COVID-19) UNCERTAINTY

Borrowing Costs IAS 23

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Disclaimer

Please note that every effort has been made to ensure that the advice given in this educational material is correct. Nevertheless, that advice is given purely as guidance to members of SAICA to assist them with particular problems relating to the subject matter of the educational material, and SAICA will have no responsibility to any person for any claim of any nature whatsoever that may arise out of, or relate to, the contents of this educational material.

1. Introduction

This educational material issued by SAICA's Accounting Practices Committee (APC) is prepared for educational purposes, highlighting the requirements within IFRS that are relevant for entities considering how the pandemic affects their accounting with a specific focus on IAS 23 *Borrowing Costs*.

Entities are reminded to consider the impact of events related to COVID-19 on both interim and annual financial statements.

This guidance does not change, remove nor add to, the requirements in IFRS. It is intended to support the sound, consistent and robust application of requirements in IFRS. It is of importance that IFRS is applied consistently on the basis of the most robust reasonable and supportable assumptions in the current environment.

2. Borrowing Costs - Application of IAS 23.

<u>The implications on the accounting for borrowing costs on suspended operations as a result of COVID-19</u>

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset form part of the cost of that asset. Other borrowing costs are recognised as an expense (IAS 23 paragraph 1).

Borrowing costs are further defined as interest and other costs that an entity incurs in connection with the borrowing of funds (IAS 23 paragraph 6).

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 to the entity and the costs can be measured reliably (IAS 23 paragraph 9).

Per IAS 23 paragraph 17, an entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;
(b) it incurs borrowing costs; and
(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

Per IAS 23 paragraph 20, an entity shall suspend capitalisation of borrowing costs <u>during extended</u> periods in which it <u>suspends active development</u> of a qualifying asset.

IAS 23 does not specify how long an 'extended period' of suspension of active development is. Entities will need to exercise judgement in this regard. In South Africa, the president announced an initial 21-day lockdown on 23 March 2020 and further announced a 14-day lockdown extension on 9 April 2020. This lockdown could potentially be considered an extended period.

Per IAS 23 paragraph 21, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. Further, an entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. An example also offered in this paragraph is that capitalisation continues during the extended period where high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

Therefore, an entity may continue to capitalise borrowing costs if:

- it continues to perform substantial administrative or technical work;
- the temporary interruption is a necessary part of the process; or
- it can demonstrate that the interruption is common during the construction period.

The COVID-19 conditions and associated lockdowns and/or restrictions are not considered to be a necessary part of the process of getting an asset ready for its intended use or sale. Further, the COVID-19 conditions and associated lockdowns and/or restrictions are also not common during the construction period of an asset. 'Common' as envisaged in paragraph 23 describes something that would have been expected to occur even at the beginning of the project. This is because something that is common would be a legitimate expected cost of the building project. From a budgeting perspective it would be expected to budget for legitimate additional costs, and at the time of budgeting, COVID-19 conditions and associated lockdowns and/or restrictions would not have been expected.

As stated above, entities need to exercise judgement as to what an extended period of suspension of active development is. The following considerations may be useful:

- The length of the delay relative to the time period ordinarily expected for the construction of the specific asset. Inherent in the definition of the term qualifying asset, is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (IAS 23 paragraph 5). The concept of a substantial period of time is not defined, and therefore requires the exercise of judgement. If the asset takes a shorter period to construct, for example 6 months or 9 months, then a lockdown period of 1 month could be considered to be an extended period of time (IAS 23 Paragraph 20).

- How far the entity was into the construction of the asset at the time of lockdown. Consider for example a 12-month project that was 9 months complete at the time of lockdown and whether the lock down period should be viewed in the context of the remaining project time (3 months) or over the total project.

- Whether the post lock down period is further extended or is a phased approach that may allow only some construction to be performed – this may pose further delays and challenges which will need to be considered in determining whether this an extended period.

- If the lock down period of non-development has caused financial distress to the entity, so much so that it has had to retrench staff and therefore may not be able to recommence development when the lockdown period ends, then in this case, the delays may be considered an extended period.

Depending on the outcome of the above analysis, the capitalisation may need to be suspended as per IAS 23 paragraph 20.

The effect of changes in the Repo Rate or terms of the loans/finance agreements.

Changes to the rate of borrowing as a result of the recent reduction in the Repo Rate, or terms of the loans/finance agreements may cause changes to the effective interest rate which may require the borrowing costs rate of capitalisation to be recomputed and adjusted prospectively.

Entities need to consider the amounts that will be capitalised if they have to negotiate revised terms in the light of depressed conditions. Borrowers may want to renegotiate terms with lenders under such extreme business conditions, which could result in changes to borrowing costs capitalised.