



**INTERNATIONAL FEDERATION  
OF ACCOUNTANTS**

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**Agenda Item**  
**7**

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**DATE:** May 1, 2009  
**MEMO TO:** Members of the IPSASB  
**FROM:** Annette Davis  
**SUBJECT:** Borrowing Costs

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**OBJECTIVES OF THIS SESSION**

- To **note** the responses received from a further request for comments on ED 35, “Borrowing Costs (*Revised 200X*)”.
- To **review** the Staff analysis of those comments.
- To **approve** the next steps for this project.

**AGENDA MATERIAL**

- 7.1 Responses to further request for clarification of submissions to ED 35, “Borrowing Costs (*Revised 200X*)”

**BACKGROUND**

1. In early 2007, the IPSASB initiated a continuous improvements project to update existing IPSASs to converge with the latest related IFRSs to the extent appropriate for the public sector. As part of that project, the IPSASB reviewed the IASB’s amendments to IAS 23, “Borrowing Costs” issued in March 2007.
2. As a result of the review of IAS 23, the IPSASB issued exposure draft (ED) 35, “Borrowing Costs (*Revised 200X*)” on September 3, 2008. It proposed amendments to IPSAS 5, “Borrowing Costs” to reflect that, in many circumstances, the capitalization of borrowing costs as part of the cost of an asset is not appropriate for public sector entities. This view, which is a departure from the current IPSAS 5 and IAS 23, is as a result of the IPSASB’s consideration of the issue in a public sector context.
3. The ED also proposed, however, that where entities borrow funds specifically to acquire, construct or produce a qualifying asset, the entity has the option to capitalize those costs as part of the cost of that asset.
4. The comment period ended on January 7, 2009. The IPSASB received 26 responses to ED 35. The IPSASB discussed a Staff analysis of the

submissions at its February 2009 meeting. Generally, the IPSASB agreed that the overall response provided no clear view and that, in some cases, there was ambiguity as to whether to finalize ED 35. However, there was also no clear indication as to the direction the IPSASB should take.

5. The IPSASB directed that the Staff should seek further clarification and additional input from all respondents through direct written correspondence. Draft minutes from the February 2009 meeting are in Appendix A.

## **OVERVIEW**

6. Staff sent a supplementary letter to each of the 26 respondents in late March 2009, asking for further clarification of their initial submission. In particular, the letter sought clarification of the respondents' views if the option was removed; would they support a requirement to capitalize borrowing costs specifically incurred for obtaining a qualifying asset or, conversely, a requirement to expense all borrowing costs. An example letter is in Appendix A of Agenda Paper 7.1.
7. The Staff received 16 responses to this further request. A list of the respondents, together with their responses is set out in Agenda Paper 7.1. Judgement has been necessary in clarifying responses and drawing out whether the overall view of the respondent is to require capitalization of borrowing costs specifically incurred for obtaining a qualifying asset or to require expensing of all borrowing costs. The analysis in this memo should therefore be read in conjunction with the responses themselves.

## **ANALYSIS OF FURTHER RESPONSES**

### **Expense all borrowing costs**

8. Nine respondents (Respondents 001, 002, 004, 008, 009, 010, 012, 015 and 016) clearly supported having a requirement to expense all borrowing costs and Respondent 007 expressed a marginal preference. Respondents 002 and 016 commented that while they preferred expensing all borrowing costs, they do not support the IPSASB's approach that there are public sector specific reasons to depart from IAS 23 on the basis of the IPSASB's "Rules of the Road". Both respondents considered that a conceptual approach is preferable.

### **Capitalize some borrowing costs**

9. Four respondents (Respondents 003, 005, 013 and 014), supported a requirement to capitalize borrowing costs. However three of these respondents believe that general funds borrowed can be directly attributable to obtaining a qualifying asset and did not believe that a requirement to capitalize borrowing costs should be limited to "specifically incurred" borrowing costs. In particular, Respondent 013 did not believe that the rationale given in the Basis for Conclusions of ED 35 is sufficient justification to depart from the requirements of IAS 23. Only Respondent 005 supported a requirement to capitalize borrowing costs specifically incurred in obtaining a qualifying asset.

**No view**

10. Two respondents (Respondents 006 and 011) gave no preference for the treatment of borrowing costs if the option is removed. Respondent 006 did not comment on which of the above accounting treatments it would prefer if the option is removed because it “considers that the treatment of borrowing costs is a subsidiary issue to the broader question of which cost should be included in the initial measurement of an asset.” Respondent 006 suggested that the current version of IPSAS 5 is kept while a further “rules of the road” analysis is undertaken. Respondent 011 also did not express a view as to which accounting treatments it would prefer if the option is removed from ED 35 because it agrees with the IPSASB’s rationale regarding expensing all general borrowing costs, but considered that this view could be inconsistent with a conceptual view of borrowing costs.

**SUMMARY AND STAFF PROPOSAL**

11. A clear majority of the respondents (ten of 16) expressed support for a requirement to expense all borrowing costs. It is also clear that of the few respondents which expressed support for a requirement to capitalize some borrowing costs, three of the four respondents considered that the IPSASB should not depart from IAS 23’s requirement for “directly attributable” borrowing costs to be capitalized.
12. Several respondents (Respondents 002, 006, 011, 012, 013, 015 and 016), either directly or indirectly, made comments encouraging the IPSASB to consider borrowing costs from a conceptual viewpoint, rather than as a convergence project. Staff agrees with this view. Therefore, Staff considers that the next step for this project is to consider the accounting treatment of borrowing costs in public sector entities from a conceptual basis. This work could be undertaken in conjunction with the IPSASB’s Conceptual Framework project.

**NEXT STEPS**

13. The summary and staff proposal section sets out the Staff proposal to consider borrowing costs in public sector entities in conjunction with the IPSASB’s Conceptual Framework project. If the Board considers that this approach is feasible, Staff considers that the following approach can be taken.
  - a. **Link to the Conceptual Framework project:** The measurement phase of the Conceptual Framework will have its first discussion at the May 2009 IPSASB meeting. Staff considers that the measurement phase is the appropriate phase of the Conceptual Framework project in which to develop further views regarding borrowing costs because it can be linked to the initial measurement of an asset.
  - b. **The status of IPSAS 5:** A decision on the status of IPSAS 5 can be deferred until further consideration of borrowing costs has been undertaken. So that, in

the meantime, the requirements of the current version of IPSAS 5 remains in force.

**Key Issue:**

**Does the Board agree with the Staff proposals for the next steps in the project?**

**APPENDIX A: EXTRACT FROM DRAFT FEBRUARY 2009 MEETING  
MINUTES**

**6. BORROWING COSTS**

**Review of Responses to ED (Agenda Item 5)**

The IPSASB considered the Staff's analysis of the responses to ED 35 "Borrowing Costs". The IPSASB's discussion noted the following points:

- Some responses were unclear;
- Preparers are generally supportive of the inclusion of an option to capitalize specifically incurred borrowing costs;
- Most of the responses received from national standard setters indicated that they did not support the inclusion of an option to capitalize specifically incurred borrowing costs;
- The focus in analyzing responses should be on the strength of reasoning not on numerical analysis.
- It was noted that at least one response had not been received by the IPSASB, although it had been sent to the correct email address twice;
- The respondents did not raise any issues that the IPSASB had not already discussed. However, the responses can help the IPSASB to improve its reasoning in the Basis for Conclusions;
- Mandating immediate expensing of all borrowing costs would result in consistency between the accounting treatment and the statistical treatment of borrowing costs;
- Until the IPSASB has completed its Conceptual Framework project it is difficult to determine the appropriate treatment for borrowing costs in the public sector.
- It is unclear whether ED 35 is an improvement upon IPSAS 5; and
- The current accounting treatment for borrowing costs varies, with some jurisdictions immediately expensing all borrowing costs, and other jurisdictions capitalizing generally attributable or specifically incurred borrowing costs.

Generally, the IPSASB agreed that there was no clear mandate from respondents to finalize ED 35. However, there was also no clear indication as to the direction the IPSASB should take. Despite some strong feelings on the subject expressed in the submissions, it was noted that the issue was less critical and urgent than most other items on the IPSASB agenda, in terms of improving either the quality of financial reporting or the quality and scope of IPSAS, and this should perhaps be reflected in the resource IPSASB devotes to this project.

Therefore, the IPSASB agreed that:

- Staff should seek further clarification and additional input from all respondents regarding their responses through direct written correspondence;

- The Chairman will raise the IPSASB's unease regarding the accounting treatment required by IAS 23, i.e., the requirement to capitalize borrowing costs that are directly attributable to obtaining a qualifying asset, at the next IASB-IPSASB Liaison Committee meeting on March 26, 2009; and
- Staff should further investigate the statistical position on borrowing costs.

Until this work is completed a decision on ED 35 will be deferred.

## **RESPONSES TO FURTHER REQUEST FOR CLARIFICATION OF SUBMISSIONS TO ED 35 BORROWING COSTS**

### **BACKGROUND**

1. At the IPSASB meeting in February 2009, the Board directed that the Staff should seek further clarification and additional input from all 26 respondents to ED 35, “Borrowing Costs (*Revised 200X*)” through direct written correspondence. An example letter is set out in 7.1.1.
2. As at April 28, 2009, the Staff has received 16 responses, as follows.

<b>Respondent Number</b>	<b>Organization</b>	<b>Country</b>
001	Office of the Auditor-General	New Zealand
002	Accounting Standards Board	South Africa
003	Auckland City Council	New Zealand
004	Swiss Public Sector Financial Reporting Advisory Committee	Switzerland
005	Accounting Standards Board	UK
006	Financial Reporting Standards Board	New Zealand
007	Audit Scotland	UK
008	Swedish National Financial Management Authority (ESV)	Sweden
009	The Japanese Institute of Certified Public Accountants	Japan
010	Manukau City Council	New Zealand
011	Chartered Institute of Public Finance and Accountancy (CIPFA)	UK
012	The Treasury	New Zealand
013	The Institute of Chartered Accountants of Scotland	UK
014	Office of the Comptroller-General - Province of British Columbia	Canada
015	Dr David Bean	US
016	Australian Accounting Standards Board	Australia

3. The responses are set out in 7.1.2.



## **International Federation of Accountants**

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Mr Todd Beardsworth  
Office of the Auditor-General  
Private Box 3928  
Wellington  
NEW ZEALAND

March 23, 2009

Dear Todd

### **Re: Exposure Draft 35 IPSAS 5 "Borrowing Costs"**

Thank you for the response to ED 35 IPSAS 5 "Borrowing Costs".

The International Public Sector Accounting Standards Board (IPSASB), at its February 2009 meeting, discussed an initial Staff analysis of the responses received.

The Board agreed that, in the light of the views of respondents, it would be inappropriate to develop a Standard that reflects the current proposals in ED 35. However, there was also no clear indication as to the direction the Board should take. Therefore, the Board agreed that certain issues should be explored further by corresponding directly with all respondents.

Many respondents indicated a preference for the removal of the option to capitalize borrowing costs specifically incurred to obtain a qualifying asset. The response indicated a preference to keep the option that entities should be permitted, but not required, to capitalize borrowing costs that are specifically incurred to obtain a qualifying asset. However, it does not appear to indicate whether, if the option was removed, whether it would be preferable to capitalize borrowing costs specifically incurred for obtaining a qualifying asset or to expense all borrowing costs. Could you please provide further rationale for your position on this issue to me by April 17, 2009? If you wish to discuss this issue by telephone, my number is +44 (0)20 7492 2432.

The IPSASB will consider a further analysis of responses at its May 2009 meeting.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Annette Davis", with a stylized flourish at the end.

Annette Davis  
Technical Manager, IPSASB



Hi Annette,

I hope you are settling into your new job and new country.

Thanks for your letter about Exposure Draft 35 IPSAS 5 Borrowing Costs (ED 35).

In Kevin Brady's letter to the IPSASB dated 22 December 2008, we noted our strong view that public sector entities must be permitted to expense borrowing costs. Therefore, if the IPSASB were to eliminate options and mandate a requirement either:

- to capitalise borrowing costs specifically incurred for obtaining a qualifying asset; or
- to expense all borrowing costs,

we are firmly of the view that the mandated requirement must be to expense all borrowing costs.

Please refer to our letter of 22 December 2008 for our reasons for the view that public sector entities must be permitted to expense borrowing costs.

Let me know if you require any further information.

Kind regards  
Todd Beardsworth



P O Box 74129  
Lynnwood Ridge  
0040  
Tel. 011 697 0660  
Fax. 011 697 0666

Ms Annette Davis  
IFAC

By email

Dear Annette

**Re: Exposure Draft 35 IPSAS 5 “Borrowing Costs”**

Your letter dated 23 March 2009 has reference.

In principal, we believe borrowing costs should always be expensed. In our opinion, the IASB revision was made as a compromise and not on a conceptual basis.

Borrowing costs should not be considered a component of cost of an asset unless a deemed charge is levied when an asset is financed from own resources or a grant. Capitalisation, when financed by borrowings, does not result in comparability.

Our comment letter reflected the view that there is no public sector specific reason to deviate from the IASB, if it is considered a convergence project. If it is not a convergence project, and it appears that at this stage it has gone beyond convergence, we believe borrowing costs should be expensed.

Should you require further clarification, please do not hesitate to contact me.

Kind regards

Erna Swart  
Chief Executive Officer

Board Members: Ms K Bromfield, Mr R Cottrell (Chairperson), Mr V Jack, Ms CJ Kujenga,  
Mr K Kumar, Mr T Makwetu, Mr F Nomvalo, Mr G Paul, Mr I Sehoole  
Chief Executive Officer: Ms E Swart

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27 March 2009

Annette Davis  
Technical Director  
International Public Sector Accounting Standards board  
International Federation of Accountants  
277 Wellington Street, 4<sup>th</sup> floor  
Toronto, Ontario M5V 3H2  
Canada

Dear Annette

**Exposure Draft 35 IPSAS 5 "Borrowing costs"**

I refer to your letter dated March 23, 2009 to:  
Mr Ravi Ganeshalingam  
Corporate Finance Manager  
Auckland City Council  
Private Bag 92 516, Wellesley Street  
Auckland 1141  
New Zealand

We would prefer to keep the option. If the option is removed we would prefer to capitalise interest on qualifying assets (In our case qualifying assets are defined as taking longer than 12 months to complete and costing in excess of NZ \$2 million).

The thrust of our argument relates to what interest can be capitalised. Our problem is with the definition of specifically incurred (loans taken out directly for a project). We believe that the definition should be widened to include general funds borrowed provided these can be directly attributed to or related to a project. NZIAS 23 Borrowing costs Sec 17 envisages such treatment and we are concerned that the proposed changes will not allow capitalisation of interest in our situation.

Auckland City council is a large local authority with a Standard and Poors "AA" rating. As such the most efficient way for us to raise funds is to go to the market with a bond issue which is designed to cover capital expenditure on a variety of projects and provide limited operational funding.

I am more than happy to discuss the issues with you and can be contacted on +64 21721122. I did try to call the number in your letter but only got an answer phone with a different name. Mr Ravi Ganeshalingam is no longer working for Auckland City Council.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Barry Davis'.

Barry Davis  
Financial Policy and Taxation Specialist

Schweizerisches Rechnungslegungsgremium für den öffentlichen Sektor (SRS)  
Conseil suisse de présentation des comptes publics (CSPCP)  
Commissione svizzera per la presentazione della contabilità pubblica (CSPCP)

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## Swiss Public Sector Financial Reporting Advisory Committee

Technical Director  
International Public Sector Accounting  
Standards Board  
International Federation of Accountants  
277 Wellington Street, 4<sup>th</sup> Floor  
Toronto, Ontario M5V 3H2  
CANADA

Chavannes-Lausanne, April 2, 2009

### Additional Comments to ED 35 “Borrowing Costs”

Dear Sir or Madam

Thank you for your enquiry of 23<sup>rd</sup> March about which solution should be preferred if the option to capitalize or to expense the borrowing costs was removed. To provide the IPSAS Board with the usual consolidated statement for all the three Swiss levels of government (municipalities, cantons and Confederation), we requested all the members of the Swiss Public Sector Financial Reporting Advisory Committee to give their view on that specific question.

The Committee's view is that it **more desirable to expense all borrowing costs**, if the option was removed. The rationale for that is that borrowing is usually centrally undertaken in most Swiss public sector entities. The borrowing of funds rather exceptionally takes place to pay for the acquisition, construction or production of a particular asset. Therefore there is ordinarily no practicable way to capitalize borrowing costs directly on any qualifying asset.

We would like thank you once more for the opportunity to put forward our views and suggestions. Should you have any questions, please do not hesitate to contact us.

Yours faithfully

SRS-CSPCP



Prof Nils Soguel, President



Sonja Ziehli, Secretary



## Accounting Standards Board

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Annette Davis  
Technical Manager  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
277 Wellington Street, 4<sup>th</sup> Floor  
Toronto, Ontario, M5V 3H2  
CANADA

2 April 2009

Dear Annette

### Exposure Draft 35: IPSAS 5 'Borrowing Costs'

This letter provides further information on the UK Accounting Standards Board's (ASB) position on the 'option' issue that was raised in IPSASB's proposals for amending IPSAS 5 'Borrowing Costs'.

The ASB response, dated 19 December 2008 argued against the proposal to permit, but not require, capitalisation where borrowing costs are specifically incurred on qualifying assets. As we explained in our response, we believe that options in accounting standards impair comparability and are therefore rarely appropriate.

We considered whether the proposed standard should require the expensing of all borrowing costs but decided against this approach on the grounds that relevant costs should be capitalised where they can be identified. One point that supported this view was the desirability of minimising divergence from IAS 23.

We also noted that, if capitalisation is restricted to borrowing costs that are *specifically incurred* for the acquisition, construction or production of a qualifying asset, entities should have no difficulty in identifying and capitalising the relevant costs.

If you would like any further information, then please contact me or Alan O'Connor on 020 7492 2421 or [a.oconnor@frc-asb.org.uk](mailto:a.oconnor@frc-asb.org.uk).

Yours sincerely

**Ian Mackintosh**

Chairman

DDI: 020 7492 2440

Email: [i.mackintosh@frc-asb.org.uk](mailto:i.mackintosh@frc-asb.org.uk)

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6 April 2009

Ms Annette Davis  
Technical Manager  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
277 Wellington Street West  
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Email: [AnnetteDavis@ifac.org](mailto:AnnetteDavis@ifac.org)

Dear Annette

### **ED 35 IPSAS 5 Borrowing Costs**

Your letter of 23 March 2009 sought clarification from the Financial Reporting Standards Board (FRSB) regarding its submission on ED 35 *IPSAS 5 Borrowing Costs*. You noted that the FRSB's submission indicated a preference for the removal of the option to capitalise borrowing costs specifically incurred to obtain a qualifying asset but did not indicate whether, if the option was removed, the FRSB would prefer to capitalise borrowing costs specifically incurred for obtaining a qualifying asset or to expense all borrowing costs. You sought further clarification from the FRSB on its position in relation to this issue.

The FRSB chose not to comment on which of these accounting treatments it would prefer because it considers that the treatment of borrowing costs is a subsidiary issue to the broader question of which costs should be included in the initial measurement of an asset. The FRSB considers that any departure from the treatment required by IAS 23 *Borrowing Costs* should be justified in the context of the IPSASB's "Rules of the Road" or in the context of the IPSASB's Framework project. The FRSB has previously commented that for the IPSASB to take a view different to IAS 23 would imply that assets in the public sector have a fundamentally different measurement objective to assets in the private sector. Any such position should be well supported by application of the "Rules of the Road".

The FRSB acknowledges, based on its own experiences, that thorough application of the "Rules of the Road" to this issue could take some time. The FRSB also notes that amending IPSAS 5 is not a critical aspect of the IPSASB's convergence project, and is a lesser priority than developing standards to fill existing gaps in the suite of IPSASs. Accordingly, the FRSB suggests that IPSAS 5 be retained unamended while the IPSASB considers the application of the "Rules of the Road" to borrowing costs. The FRSB, together with the Australian Accounting Standards Board (AASB), has been engaged in a similar exercise in New Zealand and would be happy to work with the IPSASB on this topic.

In the event that IPSASB decides to require capitalisation of borrowing costs, the FRSB would like to reiterate that it does not support the proposal to create a new category of "specifically incurred" borrowing costs.

If you have any queries or require clarification of any matters in this submission, please contact Patricia McBride ([patricia.mcbride@nzica.com](mailto:patricia.mcbride@nzica.com)) in the first instance, or me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Joanna Perry', with a stylized flourish at the end.

Joanna Perry  
**Chairman – Financial Reporting Standards Board**  
Email: [joannaperry@xtra.co.nz](mailto:joannaperry@xtra.co.nz)

Annette

Thank you for your letter of 23 March regarding ED 35 Borrowing Costs.

In my original response I said that our principal concern was with the justification being put forward by IPSASB for mandating expensing of borrowing costs. Our concern was that the rationale did not fit with the circumstances of local government in the UK which, broadly speaking, can only borrow for capital items. It is therefore in a position similar to many private sector organisations that have a central treasury management function. Using the rationale in the IPSASB proposal it was therefore difficult to see why a departure from the IAS was justified.

However for central governments and other entities that borrow generally where it is not possible or practicable to determine whether borrowing was for capital or for revenue purposes then only an expensing approach will give a consistent result with no ability for manipulation. In the UK this is not an issue for most central government bodies as they do not borrow for capital projects but are grant funded with all borrowing being by the UK Treasury which does not hard charge interest to other entities.

If consistency and clarity across all public sector entities in all countries is the overriding concern of IPSASB then I would have a marginal preference for expensing all borrowing costs over retaining the option or mandatory capitalisation.

Happy to discuss further if it would help.

Regards

Russell Frith  
Director of Audit Strategy  
Audit Scotland  
110 George Street  
Edinburgh EH2 4LH  
Direct Line: 0131 625 1607  
Switchboard: 0845 146 1010  
E-mail: [rfrith@audit-scotland.gov.uk](mailto:rfrith@audit-scotland.gov.uk)  
Web: [www.audit-scotland.gov.uk](http://www.audit-scotland.gov.uk)



Dear Annette,

We have considered your questions regarding our response to ED 35. I have been given the responsibility to send you our answer.

We can understand if you are confused from our response to the ED 35. From the view of calculating an acquisition cost value we found it most relevant to include all (calculated) capital costs incurred during construction. That means that such costs should always be calculated independently of the financing form. We however realize that such demands would be a too heavy burden to be realistic and deviate from existing standards.

With that in mind we draw the conclusion that it should be a more neutral approach to valuation if you do not capitalize interests at all. Such a solution also diminishes the workload and makes financing decisions neutral from and independent on the accounting perspective.

So, from what is now said, you can understand that we prefer a solution where you remove the capitalizing option.

Kind regards

Claes-Göran Gustavsson  
Expert redovisning och finansiering/ Senior Advisor  
Ekonomistyrningsverket (National Financial Management Authority)  
Box 45316, SE 104 30 Stockholm, Sweden  
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**April 17, 2009**

**Dear Annette Davis**

**Technical Manager**

**International Public Sector Accounting Standards Board**

**International Federation of Accountants**

**277 Wellington Street West**

**Toronto Ontario Canada M5V 3H2**

**Comments on the Proposed International Public Sector Accounting Standard,  
IPSAS 5 “Borrowing Costs” (Revised 200X)**

Dear Sir:

The Japanese Institute of Certified Public Accountants (JICPA) is pleased to comment on the Proposed International Public Sector Accounting Standard, IPSAS 5 “Borrowing Costs” (Revised 200X)” (the “ED”), as follows:

**On “Specific Matters for Comment”**

This Exposure Draft proposes that borrowing costs be recognized immediately as an expense except where borrowing costs are specifically incurred on qualifying assets. In such cases an entity is permitted, but not required to capitalize such costs (see paragraph 11). Do you agree with this proposal?

Please provide your rationale for agreeing or disagreeing with this proposal.

We agree with this proposal. The reason is as follows.

(1) Whether borrowing costs be basically recognized immediately as an expense.  
Under the revised IAS 23, borrowing costs that are directly attributable to the

acquisition, construction or production of a qualifying asset are capitalized to form part of the cost of that asset. In IAS 23, borrowing costs that are “directly attributable” to the acquisition, construction or production of qualifying assets are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. Such borrowings are not limited to funds borrowed specifically for the purpose of acquiring, constructing or producing a particular qualifying asset.

Borrowing in the public sector may be for investing or operating activities, not only for financing activities. Therefore, borrowing costs in the public sector do not always mean those that would have been avoided if the expenditure on the qualifying asset had not been made.

In conclusion, we think it rational that borrowing costs be basically recognized immediately as an expense, not capitalized.

(2) Whether an entity is permitted, but not required to capitalize borrowing costs that are specifically incurred on qualifying assets.

Borrowing in the public sector for financing activities may be allocated to deficits in the present fiscal year or to public investment on the acquisition, construction or production of a qualifying asset.

It may be rational that borrowing costs to allocate public investment on the acquisition, construction or production of a qualifying asset be capitalized when incurred, and the depreciation charge be recognized for future generations of citizens who use this asset.

In conclusion, we think it rational that an entity is permitted, but not required to capitalize borrowing costs that are specifically incurred on qualifying assets.

### **On Your Request**

If the option was removed, would you prefer to capitalize borrowing costs specifically incurred for obtaining a qualifying asset or to expense all borrowing costs ?  
please provide further rationale for your position on this issue to me by April 17, 2009.

We prefer to expense all borrowing costs. The reason is above (1).

Yours sincerely,

Yasuo Kameoka  
Takao Kashitani  
Executive Board Member  
Chair of the Public Sector Committee  
The Japanese Institute of Certified Public Accountants



Te Kaunihera o  
**MANUKAU**  
City Council

From the Directorate of:  
**FINANCE**

Technical Manager  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
277 Wellington Street, 4th Floor  
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CANADA

Via e-mail to [EdComments@ifac.org](mailto:EdComments@ifac.org)

Dear Ms Davis

**Exposure Draft of Proposed amendments to IPSAS 5 “Borrowing Costs”**

As requested, this letter is to provide more clarification regarding council's position on this issue.

The council considers that the capitalisation of borrowing costs as part of the cost of an asset is not appropriate for public sector entities. Firstly, because there would be difficulties in attributing costs to assets when construction occurs over numerous projects at the same time and when projects extend over substantial periods.

Secondly, public sector entities are valued using depreciated replacement cost and there is currently no guidance regarding the incorporation of borrowing costs into an asset valuation prepared on a depreciated replacement costs basis. Further, these assets are re-valued on a regular basis and the impact of the capitalisation of borrowing costs would be lost upon revaluation.

For these reasons, council would recommend that if the option to capitalise borrowing costs specifically incurred to obtain qualifying assets was removed, then the costs should be expensed.

If you have any further questions, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Ross Chirnside', written over a horizontal line.

Ross Chirnside  
**GROUP MANAGER FINANCIAL CONTROL**

Dear Annette

I am emailing to expand upon the comments on IPSASB ED 35 Borrowing Costs, where we set out the CIPFA view that, while the Board had provided a cost-benefit justification for expensing general borrowing costs, the Board had not provided a convincing rationale for 'optionality' where borrowing had been specifically incurred.

Per our discussion, I can confirm that, in the absence of such a rationale, CIPFA considers that the IPSAS guidance should instead eliminate the option, and require accounting on a systematic basis.

The Board has asked for our view on whether we would prefer that systematic basis to be to

- expense all borrowing costs, or
- capitalise all 'specifically incurred' borrowing.

As noted by the Board when discussing the expensing of general borrowing costs, this is a matter of cost v benefit. From a purely conceptual standpoint a preferred solution might be to capitalise financing costs whether or not they were borrowing costs, but this would be at odds with CIPFA's acceptance of the Board's cost-benefit rationale. CIPFA does not have a single view on the cost benefit question. In our internal discussions views were expressed in support of both approaches.

I hope this is helpful.

Regards

Steven

-----  
Steven Cain  
Technical Manager, Financial Reporting and Auditing Standards  
CIPFA  
3 Robert Street, London WC2N 6RL  
+44(0)20 7543 5794



AC-2-1-23

20 April 2009

Annette Davis  
Technical Manager  
International Public Sector Accounting Standards Board  
277 Wellington Street West  
Toronto, Ontario  
M4V 3H2  
CANADA

Dear Annette

**EXPOSURE DRAFT 35 IPSAS 5 “BORROWING COSTS”**

Thank you for your letter of March 23 2009. In terms of further rationale for the New Zealand Treasury’s position I have attached the responses we sent to the International Accounting Standards Board and to the New Zealand Financial Reporting Standards Board.

We also note that the majority of responses that the IASB received on this issue were negative to their proposals, as were all the responses the FRSB received. We do not consider that either the IASB nor the FRSB have adequately addressed the issues raised in these letters.

I also attach the dissenting views that Todd Beardsworth and I put to the Accounting Standards Review Board.

Please call me if you want any more information.

Yours sincerely

A handwritten signature in blue ink, which appears to read 'Ken Warren'. The signature is fluid and cursive.

Ken Warren

- Appendix A - Submission to IASB on proposed Amendment to IAS 23
- Appendix B - Submission to FRSB on proposed Amendment to NZ IAS 23
- Appendix C - Dissenting opinions on NZ IAS 23



CS/PSC-SUB/mb

Ms Annette Davis  
Technical Manager  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
277 Wellington Street, 4<sup>th</sup> Floor  
TORONTO  
Ontario M5V 3H2 CANADA

By email: [AnnetteDavis@ifac.org](mailto:AnnetteDavis@ifac.org)

22 April 2009

Dear Ms Davis

**ICAS RESPONSE TO EXPOSURE DRAFT 35 'IPSAS 5 BORROWING COSTS (REVISED 200X)'**

Thank you for your letter of 23<sup>rd</sup> March 2009 seeking additional comments from the ICAS Public Sector Committee on our preference that public sector entities are required to capitalise borrowing costs which are directly attributable to qualifying assets.

Our preference arises from our shared view with the IPSASB that International Public Sector Accounting Standards (IPSASs) should only diverge from international accounting standards when there are strong public sector reasons for doing so. In particular we would look for the core principle of an IPSAS to be the same as its equivalent IAS or IFRS unless there was a clear reason for any divergence. In this instance we believe that there is insufficient justification in ED 35 to support a revised IPSAS 5 'Borrowing Costs' which diverges from the core principle set out in IAS 23 'Borrowing Costs' which is that "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".

We believe that departing from a core principle in these circumstances could give rise to further divergence from the detail of the IAS or IFRS equivalent and that this approach in itself could undermine the IPSASB's stated intention only to diverge when there are strong public sector reasons for doing so.



If the IPSASB believes that a change of emphasis is required in respect of IPSAS 5's core principle to reflect that public sector entities are more likely to borrow funds which are not connected to a qualifying asset than the private sector, the following wording may be appropriate:

“Borrowing costs are recognised as an expense unless they are directly attributable to the acquisition, construction, or production of a qualifying asset. In such cases, borrowing costs form part of the cost of that asset.”

I hope that our comments are helpful to the IPSASB in deliberating further on this issue.

Yours sincerely



CHRISTINE SCOTT  
Assistant Director, Charities and Public Sector



April 24, 2009

CLIFF #: 217817

Via E-mail: [AnnetteDavis@ifac.org](mailto:AnnetteDavis@ifac.org)

Annette Davis  
Technical Director  
International Public Sector Accounting Standards Board  
International Federation of Accountants  
277 Wellington Street, 4<sup>th</sup> Floor  
Toronto, ON M5V 3H2

Dear Annette Davis:

**RE: IPSASB Exposure Draft 35 – IPSAS 5 “Borrowing Costs”**

Thank you for your recent letter requesting further information on our position with respect to the capitalization of borrowing costs.

We disagree with IPSAS conclusion in paragraph BC4 which states in part that IPSASB decided that it was inappropriate to require public sector entities to capitalize borrowing costs. Our reasons of disagreement were outlined in our response to the exposure draft and we have summarized these reasons below. We believe that IPSASB should have concluded that borrowing costs should be capitalized in a manner that is more consistent with International Financial Reporting Standard (IFRS) 23 on borrowing costs.

We disagree with the conclusion in paragraph BC5 of the exposure draft. This paragraph essentially states that a government with general borrowings is not able, in a meaningful way, to attribute general borrowing costs to a capital asset purchased with those borrowing costs. Governments which incur operating deficits can reasonably assume that all capital assets are financed by borrowings. Where Service Concession Agreements are undertaken, the financing cost is directly associated with the capital asset (see further discussion below); only when governments have operating surpluses does the assumption that capital assets are financed come into question. We believe

.../2

- 2 -

that when a government in a fiscal year has incremental borrowings, the government is able to attribute a portion of the borrowing costs in a meaningful way to the acquisition of the capital asset. Large construction draw downs are scheduled and should be included in cash management plans resulting in a direct impact on borrowings. We do agree, however, that if there are no incremental borrowings in a fiscal year and the government has acquired capital assets that borrowing costs should not be attributed to those capital assets.

We also believe that exposure draft 35 will result in unnecessary accounting adjustments as the separate financial statements of (GBEs), which prepare their financial statements according to IFRSs, are consolidated into the Summary Financial Statements. Exposure draft 35 on borrowing costs could result in the GBEs having capitalized borrowing costs that would have to be reversed on consolidation because they do not meet the new requirements of exposure draft 35 even though the GBEs borrowing costs are correctly capitalized according to IFRS 23. This conforming of accounting policies is required by IPSAS 6 paragraph 49 which states, "Consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances."

We believe that the proposal as presented in the exposure draft is too restrictive and as a result, it would lead to inconsistent accounting treatment of borrowing costs both within a reporting entity and between reporting entities. As we stated in our response, these inconsistencies would arise for the following reasons:

- Governments make both general borrowings and borrowings related to the acquisition of specific assets. Under the exposure draft, the borrowing costs related to the acquisition of capital assets from general borrowings would not be capitalized, even when a portion of those borrowings are used to acquire capital assets, whereas the borrowing costs related to acquisition costs of an asset acquired under a specific borrowing would be capitalized. Thus, the borrowing costs for two identical assets could be accounted for differently under the proposal. We believe that governments have enough information about general borrowing costs to impute the amount of those general fund borrowing costs that are applicable to assets acquired with those general borrowing funds.
- Another inconsistency could also arise with respect to borrowing costs incurred on assets acquired under a service concession agreement. This is because the consultation paper on service concession agreements requires assets to be valued at fair value. We believe that the competitive process associated with the service concession agreement process results in the asset's cost (as defined in the fixed price construction contract) equalling the fair value of the asset. As a result, we believe that with respect to assets acquired under a service concession agreement that borrowing costs included in the concession payments should be attributed to the asset's cost. Please see our comments on IPSASB's Consultation Paper on Accounting and Financial Reporting for Service Concession Agreements submitted under separate cover, a copy of which is attached to this letter.

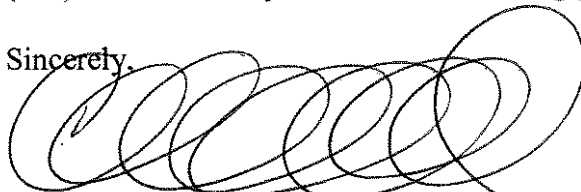
- 3 -

- Another inconsistency arises with respect to the proposal in the exposure draft that precludes the capitalization of borrowing costs related to assets which are ready for their intended use, sale or distribution when acquired. This exclusion precludes the capitalization of borrowing costs related to deposits and progress payments on readymade purchases such as trains and buses. We believe that if funds are borrowed to acquire these readymade assets that the related borrowing costs should be capitalized. Once the asset is put into use, any further borrowing costs and financing costs that are incurred should be expensed.
- We also believe that entities should not be given an option as to whether borrowing costs should be capitalized as this could lead to a lack of comparability between jurisdictions, as some jurisdictions would choose to capitalize borrowing costs and others would not.

We believe that a borrowing cost capitalization accounting principle should ensure that borrowing costs are consistently capitalized if those borrowing costs are incurred to acquire or construct a capital asset. We also believe that once the asset is put into use, that any further borrowing or financing costs that are incurred should be expensed. We further believe that borrowing costs should be imputed to the cost of the asset when a portion of a general borrowing is used to acquire a capital asset.

Should you have any comments or questions concerning this letter, please contact me at (250) 387-6692 or by e-mail: [Cheryl.Wenezenki-Yolland@gov.bc.ca](mailto:Cheryl.Wenezenki-Yolland@gov.bc.ca), or Carl Fischer, Executive Director, Financial Reporting and Advisory Services Branch, at (250) 356-9272 or by e-mail: [Carl.Fischer@gov.bc.ca](mailto:Carl.Fischer@gov.bc.ca).

Sincerely,



Cheryl Wenezenki-Yolland, CMA, FCMA  
Comptroller General

cc: Graham Whitmarsh, Deputy Minister  
Ministry of Finance

Nick Paul, Deputy Secretary to the Treasury Board  
Ministry of Finance

Carl Fischer, Executive Director  
Financial Reporting and Advisory Services  
Office of the Comptroller General

Ron Salole  
Canadian Member of IPSASB

## Capitalization of Borrowing Cost

The proceeds provided by the issuance of debt is just one of the many forms of resources used by governments to fund its operations. Some governments have constitutional or statutory limits on the use of debt proceeds. Specifically, some of these constitutional and statutory provisions limit the use of proceeds to fund capital acquisitions and construction. Moreover, some of these constitutional and statutory provisions further limit the debt issuance to specifically identified capital projects.

Despite these limitations, borrowing costs are not “a part of the activities necessary to get an asset ready for its intended use”<sup>1</sup> and therefore should not be included in the cost of acquiring a capital asset. The operative term that supports this conclusion is that the issuance of debt is not “necessary” to place an asset in use from a conceptual standpoint. Unlike other costs incurred to place a capital asset in service, issuing debt for capital assets and incurring borrowing costs are not a necessity. Instead, the issuance of debt to fund capital assets is a policy decision. A government could choose to use existing resources, raise additional resources by increasing taxes or user fees, divert resources from other activities, or issue debt to fund the acquisition or construction of a capital asset. These policy decisions are often a political means to an end. For example, a government may have a limit on the amount of resources that it can raise for operation, but have a higher limited (or in some cases, no limit) on the amount of taxes that can be raised to make debt service payments (which normally results in a lower interest rate). Once the decision is made to issue debt, the use of the proceeds from that debt may be globally limited to the acquisition or construction of capital assets or limited to the acquisition or construction of specific capital assets, but it is a *policy decision* issue debt that results in that global or specific limitation.

Although one could argue that whether or not acquire or construct a capital asset also is policy decision; that decision differs from the decision to borrow in that the capital asset acquisition or construction decision relates to what services will be provided and not how those services will be funded. In the government environment, if how a service is funded affects the cost of service calculation, it would significantly impact how and what assets are reported. Taken to its logical end, the cost of any capital asset that is funded by a gift or grant would be reduced to zero (because there is no cost to the government “necessary to get an asset ready for its intended use.”) The cost is effectively borne by the donor or grantor. The FASB took a partial step in this direction with FASB Statement No. 62, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*, where interest earned on invested bond proceeds and interest earned from invested gifts and grants are used to reduced the capitalized borrowing cost amount.

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<sup>1</sup> FASB Statement No. 34, paragraph 39 (basis for conclusions).

From an interperiod equity standpoint (which “attributes costs of the services to the period in which those services were provided and attributes revenues provided by taxpayers and other revenue providers to the appropriate period for the purpose of assessing whether those revenues were sufficient to finance the costs of providing services during that period”<sup>2</sup>) the capitalization of borrowing cost would not result in the deferral (capitalization) and allocation (depreciation) of those costs. Borrowing costs are considered to be period costs (based on GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*). Any allocation of borrowing cost would overstate the cost of the services that the cost is allocated to (for example, function or program cost) because the capitalization of borrowing cost is arguably an arbitrarily allocation. For example, if a government constructed identical two capital assets (asset A and asset B) and for political purposes decided to issue a bond where the proceeds were legally restricted to the construction of asset A (which had a higher profile and could garner the support necessary to win the voter approval for the bond issue), what would be the cost necessary to place both assets into service? If the capitalization of borrowing cost were limited to asset A, the cost of service associated with that asset would be overstated in comparison to asset B. If the borrowing costs were allocated between the two assets (a FASB Statement 34 approach), then an “all money is green” (sorry a phrase used in the States) approach is applied (at least if it results in the capitalization of an asset). If all money is truly green, then a portion of the bond cost should be allocated to programs that are not related to capital construction (thus a period cost) and the amount allocated to capitalization becomes insignificant. To address this dilemma, the GASB requires borrowing cost to be presented as a single line for governmental activities on the Statement of Activities.

In the end, the capitalization of borrowing cost is inappropriate in the public sector whether the bond proceeds are limited to capital acquisitions and construction in generally or specifically restricted to particular asset (any attempt to distinguish between the two cases would be basing the standard on the form of the debt versus the substance of the transaction). The IPSASB attempted to walk a fine line in the Exposure Draft and not be critical of the IASB (or its predecessor, the IASC); however, the IASB’s convergence with FASB Statement 34 (a Statement that is only applied in the public sector within a Business-Type Activity environment—similar to GBEs, and then only with the FASB Statement 62 modifications) has placed the IPSASB in the position where (in my opinion) we must question the wisdom of applying this private sector standard to the government environment.

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<sup>2</sup> GASB Concepts Statement No. 4, paragraph 63 (basis for conclusions)





**Australian Government**  
**Australian Accounting**  
**Standards Board**

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MELBOURNE VIC 3000  
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PO Box 204  
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29 April 2009

Ms. Annette Davis  
Technical Manager  
International Public Sector Accounting Standards Board  
277 Wellington Street West  
Toronto  
ON M4V 3H2 Canada

Dear Annette

**IPSASB ED 35 IPSAS 5 “Borrowing Costs”**

Thank you for your letter dated 23 March 2009.

The AASB is of the view that introducing the notion of ‘specifically incurred’ without explaining its connection to IAS 23’s notion of ‘directly attributable’, or not explaining ‘directly attributable’ in the public sector context, is unsatisfactory. The AASB reiterates its view that the IPSASB should only depart from IAS 23 on the basis of either public sector specific reasons that are consistent with the IPSASB’s *Rules of the Road* or on conceptual grounds.

The AASB’s response to each of your specific questions is as follows:

- (a) **What is the AASB’s preference for the removal of the option to capitalize borrowing costs specifically incurred to obtain a qualifying asset – is it to leave the option as it is in ED 35 or for the removal of the option?**

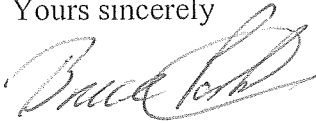
The AASB has a preference for removing the option. This would enhance comparability of financial reporting and align with IAS 23 *Borrowing Costs*.

- (b) **If the option were removed, would the AASB prefer to capitalize borrowing costs specifically incurred for obtaining a qualifying asset or to expense all borrowing costs?**

In concept, the AASB would prefer to expense all borrowing costs. However, the AASB is unable to identify public sector specific reasons for treating borrowing costs specifically incurred by a public sector entity for obtaining a qualifying asset differently from private sector for-profit entities. Therefore, on balance and with some reluctance, the AASB would support those types of borrowing costs being capitalized, consistent with IAS 23.

The AASB acknowledges the difficulty faced by the IPSASB. In terms of addressing the issue in Australia, we recently amended AASB 123 *Borrowing Costs* (equivalent to IAS 23, but applicable to for-profit and not-for-profit, including public sector, entities). In particular, it was amended to retain the option for not-for-profit public sector entities to expense borrowing costs in the period in which they are incurred, but only as an interim measure until the AASB's related projects and the IPSASB's project are finalised.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Bruce Porter', written in a cursive style.

Bruce Porter  
Acting Chairman





AC-5-6-22

4 September 2006

CommentLetters@iasb.org  
IAS 23 Amendments  
International Accounting Standards Board  
30 Cannon Street,  
London EC4M 6XH,  
**United Kingdom**

Dear Sir

## **PROPOSED AMENDMENTS TO IAS 23 BORROWING COSTS**

Thank you for the opportunity to comment on the exposure draft on the above amendments.

### **Question 1**

This Exposure Draft proposes to eliminate the option in IAS 23 of recognising immediately as an expense borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. Do you agree with the proposal? If not, why? What alternative would you propose and why?

In considering this issue, the Treasury has noted the arguments in favour of eliminating borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset set out in the basis of conclusions:

- That the proposal would achieve closer alignment and higher comparability with the required treatment under US GAAP;
- That all costs directly attributable to bringing an asset ready for its intended use should be included in the cost of an asset. Because assets developed over a period of time must be financed, applicable financing costs should be included;
- That the proposal would enhance comparability between assets that are internally developed and those that are acquired; and

- That capitalizing such costs should not impose unduly burdensome costs on entities.

The Treasury is unconvinced by these arguments:

- While closer alignment and higher comparability with the required treatment under US GAAP is a desirable objective, it should come second to the IASB's primary objective of high quality, understandable and enforceable global accounting standards;
- Borrowing raises funds that are fungible. Therefore, by definition, the costs of borrowing are not 'directly attributable' to an asset;
- The cost of assets that are acquired is primarily determined by prices determined in the market place based on supply and demand. We query why the IASB would want to seek comparability between two quite different transactions; and
- There are likely to be burdensome costs on entities where there is centralised borrowing and decentralised asset acquisition, a fact implicitly acknowledged in the grey letter in the standard. More importantly there is a greater burden placed on the users of financial statements containing an incomplete number for borrowing costs in the profit and loss account.

The Treasury objects to the proposal because the carrying amount of assets will be partially determined by the capital structure of the reporting entity, and is particularly concerned where the capital structure of reporting subsidiaries is different to that of the consolidated group. Further, the Treasury is concerned that the proposal significantly increases the ability to manipulate profit or loss particularly in entities where capital expenditure is decentralised and financing operations are centralised (the norm). We consider a superior approach that would see constructed assets recognised on completion at fair value, with the gain or loss compared to costs of construction recognised in a comprehensive income statement.

Treasury notes that this issue has been considered in some depth by National Accountants. Their approach is to use market prices for the acquisition or disposal of assets only allowing two cases in which the value of assets may be estimated from costs, namely (using 1993 SNA terms) for output produced for own use and "other non-market output." Where output produced for own use (mainly fixed assets) has to be valued on the basis of cost, this is taken to be the sum of compensation of employees, use of goods and services, and consumption of fixed capital (and taxes of production if applicable). Finance costs are not part of this equation.

While some national accountants accept that in principle finance costs should be included, their concerns about practicability, and difficulties in imputing the costs to assets have stopped them from taking this step. In addition, recent debates on this issue by National Accountants have identified that if finance costs were to be included, it would only be appropriate to use a real rate rather than a nominal rate, so that expectations about holding gains/losses incorporated in the nominal rate do not lead to double counting.

## Question 2

This Exposure Draft proposes that entities should apply the amendments to borrowing costs for which the commencement date for capitalisation is on or after the effective date. However, an entity would be permitted to designate any date before the effective date and to apply the proposed amendments to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date. Do you agree with the proposal? If not, why? What alternative would you propose and why?

If the IASB proceeds with this standard, the Treasury agrees with the proposal to permit entities to designate a date before the effective date to apply the proposed amendments to borrowing costs.

Yours sincerely



Peter Bushnell  
Deputy Secretary to the Treasury

## APPENDIX B

AC-5-6-22

4 September 2006

The Director - Accounting Standards  
New Zealand Institute of Chartered Accountants  
PO Box 11 342  
**WELLINGTON 6142**

Dear Simon

### **Proposed Amendments to NZ IAS 23 Borrowing Costs**

Thank you for the opportunity to comment on the exposure draft on the above amendments. The New Zealand Treasury has commented directly to the IASB on the proposed amendments and these comments are attached for your attention when considering FRSB's response to the IASB for its amendment.

This submission deals with the questions raised in the FRSB discussion paper on this exposure draft.

1) Do you believe the proposed amendments to IAS 23 give rise to any public benefit entity issues that require additional guidance in NZ IAS 23? If so, please describe these issues and provide reasons supporting your response.

The Treasury notes that in contrast to the private sector, in the public sector there is usually reporting by individual central government entities – that in general do not borrow but are financed from the centre – and by the whole-of-government. Central government entities that do not borrow, do not have borrowing costs to attribute to fixed assets (the capital charge mechanism is discussed below). However, under the requirements in this standard, the whole-of-government reporting entity is likely to have some borrowing costs that could be attributable to assets, no matter how arbitrary that attribution. Even if the capital charge was employed to determine borrowing costs for central government entities, differences would still exist as the capital charge is not based on the Crown's cost of borrowing.

The impact would be that physical assets developed or constructed by public sector entities would be reported in the public sector entity's financial statements at a different amount than in the whole-of-government accounts. This has a number of adverse consequences:

- Lack of consistency, despite being driven by an accounting standard seeking to promote greater consistency;
- More difficult resource allocation (capital budgeting) decisions with increased uncertainty over the cost of proposed developments; and

- Unwieldy accountability mechanisms for the management of the costs of the assets.

The second feature of central government not applicable to private sector entities is the existence of appropriations that constrain government departments from incurring expenses or capital costs above the limits specified by Parliament. The Public Finance Act ties in these definitions to GAAP definitions. Under New Zealand's appropriation regime the incurrence of borrowing costs has permanent appropriation status. There is no appropriation limit set because first, the initial approval to borrow in effect covers approval to pay associated borrowing costs and second, this provides assurance to lenders that their receipt of principal and interest is not subject to the budget process. This permanent appropriation process is not the case for other operating costs or in the approval of costs for capital projects which are generally subject to annual appropriation.

The implication of this is that implementing the proposed standard would inappropriately complicate and hinder both decision-making and accountability. Capital projects would have an element subject to constraint and an element not subject to constraint. Given the necessity for professional judgment in attributing costs between these two elements the proposal introduces unhelpful incentives into the appropriation system.

These two public sector issues are driven by the greater accountability requirements that operate in the public sector. In considering the application of this standard to the public sector, it is suggested the FRSB should consider consistency of financial reporting within the public sector as much as it considers financial reporting between the public and the private sectors.

The Treasury also notes that the introduction of this proposal would increase the reconciliation difficulties that the Government faces in preparing GFS statements and meeting New Zealand's SDDS obligations.

The Treasury therefore proposes that the current benchmark treatment be adopted for the New Zealand public sector, and the current alternative treatment be withdrawn.

2) Do you consider that public sector entities subject to the capital charge regime should treat the capital charge as a borrowing cost? Please provide reasons supporting your response.

Despite being based on the net assets of the department, Treasury considers that the amount should be treated neither as a borrowing cost, nor a return on equity but rather as an operating cost of the department or other public sector entity.

Capital charge is a cost levied on the Crown's investment in each department. From the Crown's point of view it reflects the cost to the Crown of investing in a department versus other uses of that money. From the department's point of view it represents a cost of their operations that aims at their incentives with respect to capital being aligned

with those of the Crown. Overpricing (i.e. capital charge rate set too high) will lead to substitution effects. Underpricing leads to a risk of over-investment in capital items.

The benefits of aligning these incentives in the way that the capital charge currently operates have been reviewed and tested a number of times. While most of these reviews identified areas for further investigation, all concluded the capital charge had made a positive contribution to financial management and the most economic use of scarce capital resources. All reviews recommended the capital charge should be retained in its current format.

These reports can be made available if that would be useful to the FRSB. In its current form the capital charge has achieved:

- Increased awareness of the cost of building and holding assets.
- More discipline in reviewing opportunities for disposing of surplus assets.
- Improved control of working capital.
- 'Rent or buy' decisions are better informed.
- Improved awareness of the costs of outputs.
- Improved third party charging.
- Improved 'value for money' assessments.

These benefits are obtained only if the capital charge is reflected as an internal charging mechanism levied on public sector entities. This is its economic substance.

3) Do you consider that entities qualifying for differential reporting should be permitted to expense all borrowing costs? Please provide reasons supporting your response.

The Treasury agrees with the FRSB's proposal to permit entities qualifying for differential reporting to expense borrowing costs. The requirement to analyse and allocate financing costs between those directly attributable to the construction or development of qualifying assets may not always be burdensome, but there is an additional marginal cost. On the other hand there is a benefit to be obtained from consistency with the tax treatment. Further, the impact of the imputed borrowing cost being expensed over the period of its construction rather than over the useful life of the asset is not likely to mislead users of the report.

4) Are there any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposals, particularly any issues relating to:  
a) profit-oriented entities;  
b) public benefit entities; or  
c) the Privacy Act 1993?  
Please provide reasons supporting your response.

The issues we have identified for the public sector have been covered in our response to question 1) above.

5) Do you consider that the proposals are in the best interests of users of general-purpose financial reports of entities in New Zealand? Please provide reasons supporting your response.

For profit oriented entities we consider that there are marginal gains from consistency with IFRS, however for public sector entities the Treasury would argue that the proposals are not in the best interests of those looking to use the financial information in financial statements and forecasts for either decision-making or accountability purposes.

If there are any clarifications or queries on the above, please contact Ken Warren at [ken.warren@treasury.govt.nz](mailto:ken.warren@treasury.govt.nz) or 04 471 5128.

Yours sincerely

Dr Peter Bushnell  
Deputy Secretary to the Treasury

## APPENDIX C

Date: 5 June 2007

AC-2-1-23

To: Annette Davis

From: Ken Warren  
Todd Beardsworth

### DISSENTING OPINIONS ON CAPITALISED BORROWING COSTS

The purpose of this note is to provide information on our dissenting opinions to enable you to complete the submission to the ASRB in accordance with the procedures agreed by the FRSB. We have prepared it in a format similar to that adopted by the IASB, and drawing on Ken Warren's memo to FRSB on 2 April 2007, where he informed the Board of his views.

#### Dissent of Ken Warren and Todd Beardsworth

Mr Warren and Mr Beardsworth dissent from the issue of this standard.

Mr Warren dissents because he considers that in general the raising of capital to finance an entity and the application of capital within that entity are uncoupled. Because the fungible nature of cash makes it difficult to distinguish what funds are borrowed for what purpose, costs of financing should not influence the cost of the acquisition, construction or production of assets. Mr Warren believes that where funds are not raised specifically to finance the acquisition of particular assets, attributing a part of general borrowing costs to such acquisitions as required by the standard is arbitrary and does not enhance the relevance or understandability of the financial statements.

Mr Warren also considers the amendment creates an administrative burden with no added value for the users. Extra costs will be incurred to analyse interest costs on all projects that extend over a substantial period, and for groups with centralised treasury functions, the requirement to use a consolidated view in capitalising borrowing costs adds a significant complication to the mechanics of the consolidation, particularly where there are subsidiary reporting entities with a different capital structure to that of the group.

Mr Warren acknowledges that in the case of profit-oriented entities these concerns may be offset by benefits attributable to the assertion of compliance with IFRS. In the case of public benefit entities however, he considers that this benefit needs to be balanced against the prevalence of depreciated replacement cost measurements for most assets in the public benefit sector.



Mr Warren disagrees that borrowing costs should be included in depreciated replacement cost measurements. He considers the determination of such borrowing costs to be included in such depreciated replacement cost measures is essentially an arbitrary exercise. Further, in such cases the borrowing cost, as part of the cost of the asset, will be allocated to expenses, not as the asset is used, but following revaluation in the period preceding its replacement. An expense will be reported that has not been incurred, and which, depending on the entity's capital structure, asset replacement plans and financing policies, may never be incurred. Mr Warren considers this is likely to mislead users of the financial statements, particularly the users of local authority financial statements as they seek to assess the financial position of these entities and use the financial statements as a starting point for determining the appropriate levels of future funding.

Mr Beardsworth shares the cost benefit concerns expressed by Mr Warren and the dissenting views of the IASB members in relation to IAS 23. Mr Beardsworth agrees that the adoption of NZ IAS 23 for profit-oriented entities is necessary for profit-oriented entities to assert compliance with IFRS and is consistent with the guidelines in ASRB Release 8, but notes that it is also consistent with the guidelines in ASRB Release 8 to amend recognition and measurement requirements of IFRS for public benefit entities where that is appropriate. Mr Beardsworth dissents from the issue of NZ IAS 23 because he believes its application by public benefit entities is not in the best interests of users of those entities' general-purpose financial statements at this point in time because:

- (a) There is insufficient guidance about the effect of the standard on depreciated replacement cost valuations, which are prevalent in the public sector.
- (b) The costs of compliance with the standard outweigh any benefits to users of public benefit entities' financial statements.
- (c) There has been a lack of debate about the appropriateness of public benefit entities being required to capitalise borrowing costs to qualifying assets.

Mr Beardsworth is concerned that there is no guidance and no, or little, experience in how to determine an appropriate borrowing cost element in a depreciated replacement cost valuation. Necessary judgements that could lead to significantly inconsistent conclusions include whether borrowing costs considered for capitalisation should be based on gross debt or net debt, how the period for capitalisation should be calculated and what benchmark entities to consider when determining average debt to equity ratios and average cost of debt, particularly when there is a lot of variability in size of possible comparator entities and their borrowing profiles. The concerns have arisen only now as few, if any, public benefit entities have chosen to capitalise borrowing costs under current generally accepted accounting practice.

Because this amendment will have a significant effect on the public sector given the prevalence of depreciated replacement cost valuations amongst public sector entities Mr Beardsworth considers guidance is needed at the time the standard is approved, particularly as early adoption of new or revised standards is generally encouraged and paragraph 30 of NZ IAS 8 requires disclosure of known or estimable information relevant to assessing possible impacts a new standard will have on an entity's financial statements when it is first applied. In the absence of guidance, Mr Beardsworth does

not consider that depreciated replacement cost valuations that incorporate borrowing costs will be reliable. He considers the lack of guidance will create uncertainty, increased complexity and lack of comparability and possibly unintended consequences in respect of pricing of services (e.g. an increase in local authority rates).

Mr Beardsworth notes that his concerns are shared by respondents that commented on public benefit entity issues arising from the proposed NZ IAS 23, who were concerned that there would be practical difficulties and increased costs. In his view there are no clear benefits that would outweigh these difficulties and costs and therefore it is inconsistent with an objective of high quality financial reporting standards for public benefit entities in New Zealand.

Mr Beardsworth considers the requirement for public benefit entities to capitalise borrowing costs would be an unduly hasty step for New Zealand to take given the lack of debate about the matter both nationally and internationally. He is not aware of any jurisdiction that has experience with its public benefit entities being required to capitalise borrowing costs to qualifying assets and include borrowing costs in depreciated replacement cost valuations. The International Public Sector Accounting Standards Board permits entities applying its standards a choice of either expensing or capitalising borrowing costs. He believes it is prudent to await developments in other jurisdictions or until further research is carried out into the appropriate accounting of borrowing costs by public benefit entities and appropriate valuations of infrastructure assets using depreciated replacement cost. Only then does he consider that there can be informed debate and an informed decision.