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IPSAS®

International Public Sector Accounting Standard®

Amendments to IPSAS 5, *Borrowing Costs – Non-Authoritative Guidance*

IPSASB International Public Sector Accounting Standards Board®

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In meeting this objective the IPSASB sets International Public Sector Accounting Standards™ (IPSAS™) and Recommended Practice Guidelines (RPGs) for use by public sector entities, including national, regional, and local governments, and related governmental agencies.

IPSAS relate to the general purpose financial statements (financial statements) and are authoritative. RPGs are pronouncements that provide guidance on good practice in preparing general purpose financial reports (GPFRs) that are not financial statements. Unlike IPSAS RPGs do not establish requirements. Currently all pronouncements relating to GPFRs that are not financial statements are RPGs. RPGs do not provide guidance on the level of assurance (if any) to which information should be subjected.

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AMENDMENS TO IPSAS 5, BORROWING COSTS – NON-AUTHORITATIVE GUIDANCE

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Objective

1. The objective of this pronouncement is to add non-authoritative material to IPSAS 5, *Borrowing Costs*, and to provide guidance for determining the extent to which borrowing costs can be capitalized. There are no amendments to the authoritative material. The amendments add implementation guidance and illustrative examples, which IPSAS 5 does not currently contain. The IPSASB's decisions to add non-authoritative material to IPSAS 5 are explained in the amended Basis for Conclusions.

2. The IPSASB consulted constituents in its April 2019 Measurement Consultation Paper about whether it should remove the option to capitalize borrowing costs in IPSAS 5. Feedback on this issue was mixed and the IPSASB decided to retain the existing accounting policy option in IPSAS 5. However, the IPSASB has developed additional implementation guidance and examples to illustrate the extent to which borrowing costs can be capitalized.

Summary of Non-Authoritative Guidance

Section of IPSAS 5, *Borrowing Costs*	***Summary of Non-Authoritative Guidance***
Basis for Conclusions	Explains the IPSASB decision to • Retain the accounting policy choice to capitalize borrowing costs as part of the cost of a qualifying asset when they are directly attributable to the acquisition, construction, or production of a qualifying asset (BC8 – BC14); • Add Implementation Guidance and Illustrative Examples (BC15); and • Distinguish between borrowing costs and transaction costs (BC16 – BC19).
Implementation Guidance	Guidance added to illustrate the extent to which borrowing costs can be capitalized.
Illustrative Examples	Examples added to illustrate the extent to which borrowing costs can be capitalized.

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, IPSAS 5.

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Revision of IPSAS 5 as a result of the IPSASB's Consultation Paper, *Measurement*, issued in April 2019

BC8. In April 2019, the IPSASB published the Consultation Paper, *Measurement*. The Consultation Paper proposed a comprehensive framework outlining how measurement bases should be determined when applied in the context of IPSAS. One of the objectives of the Consultation Paper was to seek feedback on whether one of the accounting policy choices in IPSAS 5, *Borrowing Costs* should be removed.

BC9. IPSAS 5 permits two accounting policy choices for borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset: capitalization or recognition as an expense.

BC10. The IPSASB proposed eliminating the option to capitalize borrowing costs in order to:

(a) Address a public sector issue where borrowing is centralized and determined for the economic entity as a whole. Expensing borrowing costs lessens the burden of attributing centralized borrowing costs to specific projects within the public sector;

(b) Enhance comparability between the cost of the acquisition, construction, or production of a qualifying asset between public sector entities; and

(c) Align more closely with the requirements in the Government Finance Statistics Manual (GFSM) 2014.

BC11. In developing its preliminary view, the IPSASB acknowledged the complexity of the issue. This complexity, and opposing views on what should be included in cost, resulted in responses to the preliminary view being split with many respondents supporting the Board's proposal, and equally, many respondents disagreeing. Those that disagreed with the proposal to remove the existing accounting policy choice considered that the reasons given for doing so were insufficient. They argued that:

(a) The difficulties in attributing borrowing costs to specific projects in the public sector were overstated and were an insufficient reason to diverge from private sector accounting treatment. Large conglomerates in the private sector face similar challenges and are able to capitalize borrowing costs;

(b) Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset are part of the cost of that asset. During the period when an asset is under development, the outlays for the resources used must be financed. Financing has a cost. The cost of the asset should include all costs necessarily incurred to get the asset ready for its intended use or sale, including the cost incurred in financing the outlays as a part of the asset's acquisition, construction, or production cost;

(c) Capitalizing directly attributable borrowing costs enhances accountability and decision making; and

(d) Immediate expensing of borrowing costs would be inconsistent with the requirements in other standards to capitalize transaction costs directly attributable to the acquisition, construction, or production of a qualifying asset.

BC12. Having reviewed the responses, the IPSASB decided to retain the existing accounting policy choice. This approach enables preparers to select the policy that best achieves the measurement objective of the qualifying asset.

BC13. The IPSASB observed the existing accounting policy choice is consistent with the measurement principles in the Conceptual Framework and allows preparers of public sector financial statements to consider the qualitative characteristics of useful information when selecting an approach that most faithfully represents the cost of the asset.

BC14. Further supporting its decision to retain the accounting policy choice, the IPSASB noted the following:

(a) Both capitalizing borrowing costs and expensing borrowing costs have technical merits. In some cases, respondents took opposite views: for example, on whether borrowing costs are an attribute of the cost of an asset;

(b) The goal of the approach when accounting for borrowing costs is to assist financial statement users in obtaining the most appropriate reflection of acquisition, construction, or production costs of a qualifying asset, which may in some cases include borrowing costs;

(c) While at certain levels of government the allocation of borrowing costs is challenging, at other levels, such as at the local government levels, it can be relatively straightforward;

(d) Capitalization of borrowing costs would align with IFRS where that is an economic entity's preferred approach, whereas the expensing of borrowing costs would demonstrate alignment with GFS if that is an economic entity's preferred approach; and

(e) There would need to be a clear benefit to expensing all borrowing costs before the IPSASB would remove the existing accounting policy choice to capitalize borrowing costs. Because there are unavoidable costs in eliminating an accounting policy choice, the IPSASB carefully considered the costs and benefits of any new pronouncement. In this case, the IPSASB had not been informed that preparers who elected to capitalize borrowing costs under IPSAS 5 found doing so unnecessarily burdensome.

BC15. Some respondents to the Consultation Paper identified practical public sector challenges in capitalizing borrowing costs. The IPSASB therefore developed Implementation Guidance and Illustrative Examples to assist entities in determining the extent to which borrowing costs can be capitalized.

Distinction between borrowing costs and transaction costs

BC16. In reaching the conclusion to retain the accounting policy choice, the IPSASB noted that accounting for borrowing costs may not be consistent with accounting for transaction costs. Some respondents proposed that the accounting treatment of borrowing costs and transaction costs should be consistent because they considered either:

(a) Borrowing costs to be a type of transaction costs. Borrowing costs are directly attributable to the borrowing (for example, the issuance of a government financial instrument). Therefore, they meet the criteria of a transaction cost; or

(b) Transaction costs to be a type of borrowing costs. Some respondents proposed this view based on the methodology applied in calculating the effective interest rate of a financial instrument. This is because some transaction costs are added to, or subtracted from, the principal amount of a financial instrument when determining the gross proceeds of a borrowing in order to determine the effective interest rate.

BC17. The IPSASB considered these views, but decided that borrowing costs and transaction costs are different economic phenomena. The IPSASB concluded it is appropriate for the accounting principles to differ for each type of “cost” depending on the facts and circumstances.

BC18. In reaching this view, the IPSASB noted that borrowing costs comprise interest and other expenses incurred by an entity in connection with borrowing funds. Borrowing costs are often contractually linked to the underlying borrowing. Should the borrowing be transferred, the borrowing costs would either be transferred to the new counterparty or separated contractually.

BC19. Transaction costs are incremental costs directly attributable to the transaction. However, transaction costs are independent of the contractual terms of the debt instrument. Should the debt instrument be transferred, the entity transferring the instrument is generally not compensated for the transaction costs because they are not transferred to the counterparty assuming the instrument.

Implementation Guidance

This guidance accompanies, but is not part of, IPSAS 5.

A.1 Period of Borrowing Cost Capitalization

When applying the allowed alternative treatment, as described in paragraphs 17–18, when can an entity begin to include borrowing costs in the cost of the qualifying asset?

Where outlays and borrowings have been incurred specifically to fund a qualifying asset's acquisition, construction, or production, the costs of those borrowings should be capitalized when the activities necessary to prepare the asset for its intended use or sale begin. The activities necessary to get the asset ready for use encompass more than the asset's physical acquisition, construction, or production. The activities include technical and administrative work prior to the commencement of physical acquisition, construction, or production, but exclude holding the asset when no development that changes the asset's condition is being undertaken.

The activities (i.e., technical and administrative work) undertaken prior to commencement of the physical acquisition, construction, or production of a qualifying asset should contribute to the actual development or construction of that asset.

A.2 Limit on Capitalization

When applying the allowed alternative treatment, as described in paragraphs 17–18, to specific borrowings, are borrowing costs included in the cost of the qualifying asset in that period limited to the borrowing costs incurred in that period?

Yes. If a borrowing can be specifically associated with outlays on acquisition, construction, or production of a qualifying asset, the amount of borrowing costs capitalized during that period is limited to the borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

A.3 Asset Funded through Transfers

In many jurisdictions, the acquisition, construction, or production of a qualifying asset is funded through a transfer from another public sector entity. Does the entity acquiring, constructing, or producing the qualifying asset consider the transferor's underlying source of the funds, i.e., whether the funds are generated by tax revenues, general cash holdings or borrowings, when it determines the amount that can be included in the cost of the qualifying asset when applying the allowed alternative treatment, as described in paragraphs 17–18?

No. When the acquisition, construction, or production of a qualifying asset is fully funded through a transfer, there will be no directly attributable borrowing costs to capitalize. The entity may include in the cost of the qualifying asset only those borrowing costs which it has incurred.

A.4 Asset Funded through a Centralized Lending Program – Interest Rates

A centralized lending agency may fund its activities by borrowings through several separate loan instruments. Each instrument may have a different interest rate. An entity may borrow funds from the centralized lending agency and use these funds for the acquisition, construction, or production of a qualifying asset. If the entity is using the allowed alternative treatment, as described in paragraphs 17–18, does the entity apply the weighted average interest rate incurred

by the centralized lending agency when including borrowing costs in the cost of the qualifying asset?

No. The weighted average interest rate incurred by the centralized lending agency is not relevant in the preparation of the financial statements of the entity acquiring, constructing, or producing the qualifying asset. The entity can include in the cost of the qualifying asset only those borrowing costs which it itself has incurred.

The entity must consider all facts and circumstances when determining the borrowing costs incurred in its arrangement with the centralized lending agency. In some cases, the interest rate stated in the terms of the arrangement may not reflect the true borrowing costs associated with the funds received. When the entity identifies concessionary terms, the entity should apply the requirements in IPSAS 41, *Financial Instruments*, paragraphs AG118–AG127[1] and capitalize borrowing costs based on a market related interest rate that the entity would have incurred on a similar loan (see IPSAS 41, IE153-IE172 for examples illustrating how to determine the interest rate in a concessionary loan). Interest expense calculated using the effective interest rate method is eligible for inclusion in the cost of the qualifying asset in accordance with this Standard.

If the centralized lending agency and the entity to which it lends funds are part of the same economic entity, in the financial statements of the consolidated entity, the borrowing costs incurred by the centralized lending agency can be capitalized to the qualifying asset, provided that appropriate consolidation adjustments have been made to eliminate those costs capitalized by the controlled entity.

A.5 Asset Funded through an Entity's Own General Borrowing – Borrowings are not Specific to Qualifying Asset

When an entity acquiring, constructing, or producing a qualifying asset manages its own borrowing program, but borrowings are not specific to the qualifying asset, how does the entity determine the borrowing costs directly attributable to the qualifying asset? This may occur when an entity uses cash on hand to fund the cost of a qualifying asset. This cash on hand is funded from general borrowings, tax revenue and other fees and transfers.

The amount of borrowing costs eligible for inclusion in the cost of the qualifying asset is determined using the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period. The weighted average of borrowing costs is then applied to the outlays on the qualifying asset incurred during the period in determining the amount eligible for capitalization.

The entity shall exclude from the weighted average calculation, those borrowings that are made specifically for the purpose of obtaining another qualifying asset until substantially all the activities necessary to prepare that asset for its intended use are complete. The amount of borrowing costs capitalized during a period shall not exceed the amount of borrowing costs incurred during that period.

[1] Where an entity has not yet adopted IPSAS 41, the requirements in IPSAS 29, *Financial Instruments: Recognition and Measurement*, paragraphs AG84-AG90 are applied. Similar to the IPSAS 41 requirements, an entity should capitalize borrowing costs based on a market related interest rate that the constructing entity would have incurred on a similar loan.

A.6 Asset Funded through General Borrowings – Range of Debt Instruments

Does an entity apply a weighted average of borrowing costs when multiple debt instruments are used to fund the cost of a qualifying asset?

Yes. An entity may not be able to fund the cost of a qualifying asset with a single debt instrument. When multiple debt instruments are used, the cost of borrowing is determined by calculating the weighted average of the borrowing costs applicable to all the debt instruments outstanding during the period, excluding borrowings that are made specifically for the purpose of obtaining another qualifying asset (until substantially all the activities necessary to prepare that asset for its intended use are complete).

Illustrative Examples

These examples accompany, but are not part of, IPSAS 5.

Qualifying Asset Constructed Over a Period of Time

IE1. On March 31, 20X1, Municipality XYZ begins construction of a tunnel to accommodate transit between two commercial hubs. The construction period is 5 years and the project is budgeted to cost CU100 million (CU20 million is paid to the construction company on the date the construction begins and on March 31 of each subsequent year during the construction period). Municipality XYZ issues a 25-year CU100 million bond on March 31, 20X1 that yields a fixed coupon of 5 per cent per annum. This bond was issued specifically to finance the construction of this project. The Municipality has a December 31 year end and earns a rate of interest of 3 percent on the temporary investment of any excess borrowings.

IE2. On December 31, 20X1, the Municipality has accrued borrowing costs of CU3.75 million (CU100 million x 5 percent x 9/12 months).

IE3. In determining the borrowing costs that can be included in the cost of the tunnel, the Municipality is limited to capitalizing the borrowing costs incurred during the period less any investment income on the temporary investment of those borrowings.

IE4. At December 31, 20X1, Municipality XYZ recognizes its tunnel asset as a work in progress. The amount capitalized is CU21.95 million (CU20 million + [CU100 million x 5 percent x 9/12 months] – [CU80 million x 3 percent x 9/12 months]). This represents the funds transferred to the construction company and the borrowing costs incurred during the period less the investment income earned on the CU80 million invested.

Centralized Borrowing Program – Eligible Borrowing Costs

IE5. The Department of Infrastructure begins construction of a new road network on June 15, 20X1. The project costs are budgeted to be CU500 million. All financing required by the Department of Infrastructure, and all other government departments, is secured centrally by the Department of Finance.

IE6. The Department of Finance estimates its cash flow needs on an annual basis in order to determine the most appropriate source of funding to meet its internal lending needs. These sources include tax revenue, fee revenue, bonds issuances and loans.

IE7. The Department of Infrastructure negotiates a 10-year loan from the Department of Finance. The Department of Finance requires the Department of Infrastructure to pay borrowing costs of 3 percent per annum. This is consistent with the market rate of interest the Department of Infrastructure would incur if the arrangement was negotiated at arm's length.

IE8. When the Department of Infrastructure secures financing from the Department of Finance, the Department of Infrastructure is aware borrowings comprise various sources, but has no visibility of how the Department of Finance sources the funds, nor of the weighted average borrowing costs the Department of Finance incurs.

IE9. In determining the borrowing costs eligible for inclusion in the cost of the road network, the Department of Infrastructure includes only those borrowing costs which it itself has incurred. Because the loan is at market terms, the Department of Infrastructure concludes there are no concessionary elements and determines borrowing costs eligible for inclusion in the cost of the road network are based on the interest rate of 3 percent stated in the contract.

General Borrowing – Weighted Average Cost of Borrowing

IE10. State Government T has begun construction of a new airport. The cost of this airport is budgeted to be CU500 million. State Government T manages its own borrowings; however, it does not borrow for specific projects. In determining its borrowing needs, State Government T budgets its cash shortfall over a given period and ensures borrowings will cover its liquidity needs.

IE11. Over the construction period, State Government T held three instruments that were open for the entire construction period:

- State Bonds – CU1 billion, yielding an annual rate of 5 percent;
- Loan with Financial Institution A – CU300 million, with an annual interest rate of 7 percent; and
- Loan with Financial Institution B – CU600 million, with an annual interest rate of 9 percent.

IE12. In determining the amount of borrowing costs eligible for inclusion in the cost of the airport, State Government T calculates the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period.

	A **Principal**	**B** **Interest Rate**	**C** **Proportion of Debt**	**D = B x C** **Weighted Average**
State Bonds	CU1,000 million	5 percent	1,000 / 1,900	2.63
Loan A	CU300 million	7 percent	300 / 1,900	1.11
Loan B	CU600 million	9 percent	600 / 1,900	2.84
Weighted Average Interest Rate				**6.58 percent**

IE13. State Government T calculates the weighted average of the borrowing costs applicable to all borrowings of the entity outstanding during the period to be 6.58 percent.

Specific Borrowing – Borrowing for Part of Qualifying Asset's Amount

IE14. State Government C began construction of a new road network on January 1, 20X1. The cost of this road network is budgeted to be CU750 million. State Government C funds this project with amounts received on January 1, 20X1 from two sources:

- Federal grant in the amount of CU500 million; and
- Loan from a financial institution of CU250 million, with an annual interest rate of 5 percent.

In order to receive the federal grant, State Government C was required to show it was able to secure financing. It is State Government C's policy to allocate borrowed funds to the construction of the qualifying asset first. State Government C earns a rate of interest of 3 percent on the temporary investment of any excess borrowings.

IE15. As at December 31, 20X1, State Government C has incurred outlays of CU200 million as part of the construction of the asset. These outlays were transferred in one lump sum payment to the construction company at the commencement of construction on January 1, 20X1. In addition to the outlays of CU200 million, State Government C capitalizes CU11 million ([CU250 million x 5 percent] – [CU50 million x 3 percent]) in borrowing costs, against the qualifying asset.

IE16. Because State Government C borrowed CU250 million for the purposes of obtaining the road network, but has only incurred outlays related to that qualifying asset in the amount of CU200 million, State Government C was able to earn interest revenue on the excess funds borrowed. State Government C capitalized borrowing costs incurred during the period of CU12.5 million less the investment income of CU1.5 million on the temporary investment of those borrowings.

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529 Fifth Avenue, New York, NY 10017
T + 1 (212) 286-9344 **F** +1 (212) 286-9570
www.ipsasb.org