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Item 5 of the Agenda

Draft EPSAS Screening Report
IPSAS 5 – Borrowing costs

Paper by PwC in cooperation with Eurostat

- for discussion -

This document was commissioned by Eurostat. It analyses the consistency of the named IPSAS standard with the draft EPSAS framework, with a view to informing future EPSAS standard setting. This version was prepared taking into account comments received from the participants of the Cell on Principles related to EPSAS Standards.

EPSAS screening report

IPSAS 5 - Borrowing costs

April 2021

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Background

Objectives

Reference is made to the general introduction to the EPSAS screening reports that covers the following elements:

- Key objectives of EPSAS.
- Standard setting process in the public sector.
- Purpose and scope of the screening reports.
- Approach of the screening reports.
- European public good.
- Common elements considered when preparing the reports.

General introduction to IPSAS 5

IPSAS 5 is drawn primarily from International Accounting Standard (IAS) 23 ‘Borrowing Costs’, issued by International Accounting Standards Board (IASB). In developing IPSAS 5, the International Public Sector Accounting Standards Board (IPSASB) applied its ‘Process for Reviewing and Modifying IASB Documents’ that identifies public sector modifications where appropriate. This approach enables the IPSASB to build on best practices in private sector financial reporting, while ensuring that the unique features of the public sector are addressed.

IPSAS 5 prescribes the accounting treatment for borrowing costs.

Key definitions in the standard are as follows:

- Borrowing costs are interest and other expenses incurred by an entity in connection with the borrowing of funds.
- Qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (IPSAS 5 para 5).

IPSAS 5 allows the following accounting policy choice for borrowing costs:

- Benchmark treatment: borrowing costs are recognised as an expense in the period in which they are incurred (IPSAS 5 para 14).
- Allowed alternative treatment: borrowing costs are recognised as an expense in the period in which they are incurred, except to the extent that they are capitalised. Borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset are capitalised as part of the cost of that asset (IPSAS 5 para 17-18).

Scope of the report

The International Public Sector Accounting Standards Board (IPSASB®) issued IPSAS 5 ’Borrowing costs’ in May 2000. The present screening report analyses the accounting treatment for borrowing costs.

The International Public Sector Accounting Standards Board (IPSASB) released (on 21 October 2020) for comment Exposure Draft (ED) 74, IPSAS 5 ‘Borrowing Costs - Non-Authoritative Guidance’. The ED proposes the addition of non-authoritative guidance to IPSAS 5.

The proposed non-authoritative guidance would add implementation guidance and illustrative examples to IPSAS 5. The new material proposed in ED 74 would clarify how the existing principles for when borrowing costs can be capitalised should be applied in various regularly encountered public sector contexts. No amendments are proposed to the authoritative material in IPSAS 5. Retaining the capitalisation option would give the different jurisdictions the possibility to adapt their accounting policy choice to their objectives e.g. alignment with GFS (expense) or with IFRS (capitalisation).

The present screening report does not anticipate the outcome of the public consultation on ED 74. This will need to be monitored as part of the EPSAS standard setting.

Reference to EFRAG assessment

No specific individual technical assessment of IAS 23 ‘Borrowing Costs’, the IFRS equivalent of IPSAS 5, was carried out by the EFRAG, and therefore no specific individual endorsement report was produced.

The EFRAG however provided on 19 June 2002 a positive assessment of all IAS standards existing at 1 March 2002, including IAS 2, as part of the overall introduction of IAS within the EU.

Reference to EPSAS issue papers[1]

The PwC study of 2014[2] analysed the suitability of the IPSAS standards as a basis for developing EPSAS. Member States have been asked to provide their comments on the application of IPSAS in an open way. IPSAS 5 was classified as a standard that was assessed to be acceptable for use by EU Member States without adaptation or with only minor adaptation.

In the course of developing the technical proposal on EPSAS, Eurostat commissioned a series of twenty technical issues papers (IPs), which analyse key

[1] EPSAS Issues papers are available on https://ec.europa.eu/eurostat/web/epsas/key-documents/technical-developments

[2] Collection of information related to the potential impact, including costs, of implementing accrual accounting in the public sector and technical analysis of the suitability of individual IPSAS standards (Ref. 2013/S 107-182395)

public sector specific accounting issues. The papers were discussed at the EPSAS Working Group meetings during 2016-2018. The papers are all publicly available on Eurostat's website.

Each of the IPs seek to identify conclusions and key issues for further discussion. Taking into consideration the analyses provided in the IPs and the initial views exchanged with Member States' public sector accounting experts during the Working Group meetings, Eurostat drew tentative conclusions that may serve, together with the IPs themselves, as considerations for future standard setting.

No EPSAS issue paper was prepared on the topic of borrowing costs.

Screening of IPSAS 5 'Borrowing costs' against criteria set in the draft EPSAS framework

Introduction

The EPSAS criteria listed in the draft EPSAS framework have been used to perform an assessment of IPSAS 5 'Borrowing costs', published in 2000 by the IPSASB, with minor amendments made from that date.

In order to develop recommendations, one should first consider whether IPSAS 5 would meet the qualitative characteristics of the draft EPSAS CF, i.e. whether it would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information and would not be contrary to the true and fair view principle.

This report considers recognition, measurement and disclosure requirements applicable to inventories for each of the qualitative characteristics of the draft EPSAS CF.

Further, this paper includes a high-level comparison between the requirements of IPSAS 5 and other international accounting and financial reporting frameworks applied by the public sector entities in various jurisdictions, such as IFRS, ESA 2010 and EU Accounting Rules, bearing in mind the objective of alignment, reduction of cost of implementation and compliance cost.

Finally, the paper assesses whether IPSAS 5 would be conducive to the European public good.

The findings are presented below, and the conclusion is included in the next section of this report.

Conformity with Qualitative Characteristics

Relevance

Financial and non-financial information is relevant if it is capable of making a difference in achieving the objectives of GPFRs. Financial and non-financial information is capable of making a difference when it has confirmatory value, predictive value, or both.

The objective of IPSAS 5 is to prescribe the accounting treatment for borrowing costs. IPSAS 5 generally requires the immediate expensing of borrowing costs. However, it permits, as an allowed alternative treatment, the capitalisation of borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset (IPSAS 5 para 1).

Borrowing costs may include:

(a) Interest on bank overdrafts and short-term and long-term borrowings.

(b) Amortisation of discounts or premiums relating to borrowings.

(c) Amortisation of ancillary costs incurred in connection with the arrangement of borrowings.

(d) Finance charges in respect of finance leases and service concession arrangements.

(e) Exchange differences arising from foreign currency borrowings, to the extent that they are regarded as an adjustment to interest costs (IPSAS 5 para 6).

IPSAS 5 allows an accounting policy choice for borrowing costs. These can either be expensed or capitalised if they are directly attributable to the acquisition, construction, or production of a qualifying asset. Under the allowed alternative treatment, borrowing costs can be capitalised as part of the cost of the asset when (a) it is probable that they will result in future economic benefits or service potential to the entity, and (b) the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred (IPSAS 5 para 19).

The asset recognition principles of IPSAS 5 are consistent with the definition of an asset in the draft EPSAS CF. As a reminder, an asset is a resource presently controlled by the entity as a result of past events or transactions. A resource is an item with service potential or the ability to generate economic benefits. Service potential is the capacity to provide services that contribute to achieving the entity's objectives. Economic benefits are cash inflows or a reduction in cash outflows.

The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence when:

(a) Outlays for the asset are being incurred;

(b) Borrowing costs are being incurred; and

(c) Activities that are necessary to prepare the asset for its intended use or sale are in progress (IPSAS 5 para 31).

To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period, less any investment income on the temporary investment of those borrowings (IPSAS 5 para 23).

The information about borrowing costs that are capitalised is relevant because it helps the users estimate the future economic benefits or service potential of qualifying assets that are owned or used for the long term by a public sector entity. In addition, it has a confirmatory value because it shows the level of investment made in the past in the long-term assets that are being used by the government.

Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted, and expensed (IPSAS 5 para 34). This is because they then do not relate to the construction of an asset. Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete (IPSAS 5 para 36). When the construction of a qualifying asset is completed in parts, and each part is capable of being used while construction continues on other parts, capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare that part for its intended use or sale are completed (IPSAS 5 para 38).

Based on the above requirements, IPSAS 5 provides users of financial statements with relevant information on borrowing costs, therefore enhances the relevance of financial information in accordance with the draft EPSAS CF.

Faithful representation / Reliability

To be reliable, financial and non-financial information must provide a faithful representation of the substance of economic and other phenomena that it purports to represent. The notion of faithful representation and reliability in the draft EPSAS CF is linked to the qualitative characteristics of completeness, prudence, neutrality, verifiability, substance over form and being free from material error. These characteristics are separately discussed below.

To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the outlays on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to all borrowings of the entity that are outstanding during the period. However, an entity should exclude from this calculation borrowing costs applicable to borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period (IPSAS 5 para 25).

Outlays on a qualifying asset include only those outlays that have resulted in payments of cash, transfers of other assets, or the assumption of interest-bearing liabilities. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the outlays to which the capitalisation rate is applied in that period (IPSAS 5 para 32).

The benchmark treatment is simple to implement and therefore provides reliable information. Under the allowed alternative treatment, the method of calculating the capitalisation rate for purpose of allocating borrowing costs to qualifying assets should provide reliable financial information. IPSAS 5 enhances a faithful representation of the economic phenomena and fulfil the QC 'Reliability' of the draft EPSAS CF.

Completeness

The information which fulfils the recognition criteria should be complete within the bounds of materiality and cost-benefit considerations.

The allowed alternative treatment foresees the capitalisation of all borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset. This requirement satisfies the QC of completeness.

The required disclosures in relation to the application of the allowed alternative treatment include:

(a) The accounting policy adopted for borrowing costs.

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

(c) The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation (when it was necessary to apply a capitalisation rate to funds borrowed generally) (IPSAS para 40).

Based on the assessment, IPSAS 5 satisfies the completeness QC of the draft EPSAS CF.

Prudence

Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty, such that assets or revenue are not overstated while liabilities or expenses are not understated.

The benchmark treatment of IPSAS 5 takes a prudent approach to the accounting of borrowing costs. Under this approach, borrowing costs are expensed as incurred rather than capitalised on the balance sheet.

Under the allowed alternative treatment, the capitalisation of borrowing costs should stop when the development of the asset has ceased. In addition, the amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period (IPSAS 5 para 25). Those requirements avoid overstating the carrying amount of qualifying assets and therefore meet the QC of prudence.

Besides this, there are no other significant complexities arise as a result of the application of the standard, therefore, it meets the QC ‘Prudence’ of the EPSAS CF.

Neutrality

Information is neutral if it is free from bias. GPFSs are not neutral if the information they contain has been selected or presented in a manner designed to influence the making of a decision or judgment in order to achieve a predetermined result or outcome.

The principles included in IPSAS 5 have been tested for many years in the private sector. The requirements to apply accounting policies consistently year on year and to disclose such policies in the notes to the accounts reinforce the neutrality QC.

In a principles-based accounting framework, the use of judgement is an inherent factor, and the disadvantage of applying principles instead of rules, is that there might be divergence in practice. When the allowed alternative treatment is applied and the funds are not borrowed specifically for the financing of a qualifying asset, some level of judgment may be required when determining the portion of borrowing costs to be capitalised. The level of judgment required by IPSAS 5 is not so exceptional in nature that it would be impracticable to apply the standard in a consistent manner and achieve the neutral presentation of the reporting entity.

Verifiability

The ‘Verifiability’ QC is achieved when the quality of information helps assure users that GPFSs is based on supporting evidence in a way that it faithfully represents the substance of economic and other phenomena that it purports to represent.

Application of the standard is easy to verify when the benchmark treatment is applied, or the allowed alternative treatment is used, and the funds are borrowed specifically to finance a qualifying asset.

When borrowing costs are capitalised and no specific borrowing is made, some level of judgment might be required. The principles for calculating the capitalisation rate described in the standard should however facilitate the verifiability of the accounting treatment applied by way of tracing back to supporting documents and underlying records. The amount of borrowing costs capitalised during a period should also not exceed the amount of borrowing costs incurred during that period. Finally, the disclosures about the amount of borrowing costs capitalised during the period and the capitalisation rate used in the case of funds borrowed generally enhance the verifiability QC.

Overall, the requirements of the standard support the QC 'Verifiability' of the draft EPSAS CF.

Substance over form

The 'Substance over form' QC requires that the underlying transactions, other events, activities or circumstances are accounted for and presented in accordance with their substance and economic reality, and not merely their legal form.

IPSAS 5 allows those entities that construct assets that take a substantial period of time to get completed to capitalise the borrowing costs relating to the construction of these assets. Such an accounting treatment aims at reflecting the substance of the transaction by comprehensively accounting for all costs directly attributable to the construction of the asset.

Only those borrowing costs applicable to the borrowings of the entity may be capitalised. Specifically:

- When a controlling entity borrows funds that are passed on to a controlled entity with no, or only partial, allocation of borrowing costs, the controlled entity may capitalise only those borrowing costs which it itself has incurred. Where a controlled entity receives an interest-free capital contribution or capital grant, it will not incur any borrowing costs, and consequently will not capitalise any such costs (IPSAS 5 para 26).
- When a controlling entity transfers funds at partial cost to a controlled entity, the controlled entity may capitalise that portion of borrowing costs which it itself has incurred (IPSAS 5 para 27).
- When a controlling entity has transferred funds at no cost to a controlled entity, neither the controlling entity nor the controlled entity would meet the criteria for capitalisation of borrowing costs (IPSAS 5 para 28).

The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place (IPSAS 5 para 33).

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets, and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale (IPSAS 5 para 35).

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that is outstanding, this indicates that substantially all the activities are complete (IPSAS 5 para 37).

These requirements result in an accounting treatment that properly reflects the substance of the borrowing transaction. IPSAS 5 therefore fulfils the QC 'Substance over form' of the draft EPSAS CF.

Understandability

The 'Understandability' QC is the quality of presenting information in a manner that facilitates expert and non-expert users to comprehend its meaning. Understandability is enhanced when information is classified, characterised and presented clearly and concisely.

The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence. Although there are several aspects to the notion of 'understandability', most of the aspects are covered by the discussion above about relevance, reliability and comparability.

Based on an overall assessment, the principles of IPSAS 5 do not raise any significant issues that may impair understandability. The accounting treatment of borrowing costs under IPSAS 5 provides understandable information to the users of the financial statements.

Comparability

Comparability is the quality of information that enables users to identify similarities in, and differences between, two sets of phenomena in different reporting entities or in one reporting entity at different points in time. A key objective of EPSAS is to achieve the necessary level of financial transparency and comparability of financial reporting, between and within EU Member States.

The existence of an accounting policy option may impair the comparability of government financial statements in the EU. Cost-benefit considerations should guide the choice of a particular accounting method versus another. Different users of financial statements may however have different views of what these costs or benefits are. Where an entity adopts the allowed alternative treatment, that treatment should be applied consistently to all borrowing costs that are directly attributable to the acquisition, construction, or production of all qualifying assets of the entity (IPSAS 5 para 20).

In addition, when the allowed alternative treatment is selected and funds are borrowed generally, the use of judgment and estimates (e.g. when identifying a direct relationship between particular borrowings and a qualifying asset or when computing the weighted average of borrowing costs when calculating the capitalisation rate) may have some -most likely marginal - impact on the comparability of financial statements.

The borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset are those borrowing costs that would have been avoided if the outlays on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified (IPSAS 5 para 21).

However, it may be difficult to identify a direct relationship between particular borrowings and a qualifying asset, and to determine the borrowings that could otherwise have been avoided. For example when the financing activity is coordinated centrally and an economic entity uses a range of debt instruments to borrow funds at varying rates of interest and transfers those funds as a loan, grant or capital injection on interest-free basis or where only a portion of the actual interest cost to be recovered to other entities in the economic entity). Other complications arise (a) through the use of loans denominated in or linked to foreign currencies, (b) when the economic entity operates in highly inflationary economies, and (c) from fluctuations in exchange rates (IPSAS 5 para 21-22).

In some circumstances, it is appropriate to include all borrowings of the controlling entity and its controlled entities when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each controlled entity to use a weighted average of the borrowing costs applicable to its own borrowings (IPSAS 5 para 29).

Considering the above, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset and computing a weighted average of the borrowing costs could require to exercise a certain level of judgment.

Overall, cost-benefit considerations should guide the choice of a particular accounting policy versus another: expensing or capitalising borrowing costs. Allowing an accounting policy choice increases the relevance of information for governments that have a preference in using one of the two methods for accountability and decision-making purposes. In addition, in case an accounting policy choice would be possible, application of the requirements of IPSAS 5 combined with appropriate disclosures provided in the notes about the accounting treatment applied mitigates the lack of comparability.

Alignment with other frameworks

ESA 2010

Alignment with ESA reporting is desirable, to avoid the burden of a dual reporting in the public sector. Differences with ESA 2010 reporting requirements should be avoided where possible, both regarding the scope of entities to be included in the IPSAS scope of reporting and the IPSAS requirements in terms of measurement and disclosures.

In contrast to IPSAS 5, ESA 2010 does not permit capitalisation of borrowing costs. The option to capitalise borrowing costs may be further assessed to determine whether it should be retained and whether the alignment between ESA reporting and EPSAS should be permitted or required in this area. It should be noted that the option (where applicable in the context of government activities) affects not solely the presentation of information in the financial statements but also the recognition of elements in the statement of financial position and surplus/deficit.

IFRS[3]

IPSAS 5 'Borrowing Costs' is drawn primarily from IAS 23 'Borrowing Costs'. The main differences between IPSAS 5 and IAS 23 are as follows:

- IPSAS 5 uses different terminology, in certain instances, from IAS 23.
- IPSAS 5 contains a different set of definitions of technical terms from IAS 23 (paragraph 5).
- Revised IAS 23 Borrowing Costs (March 2007) eliminated the option of immediate recognition of borrowing costs as an expense.

EU accounting rules

European Union Accounting Rules (EAR) constitute the accounting framework of the European Union Institutions, including the European Commission (EC) and its agencies.

There is no specific accounting rule developed for borrowing costs as the Commission is typically not involved in such transactions.

In EU AR 7 'Property, plant and equipment' the subsection about measurement of cost presents no guidance on the treatment of borrowing costs except for the following statement:

'The cost of an item of property, plant and equipment is the cash price equivalent or, for an item acquired through a non-exchange transaction, its fair value at the

[3] Refer to the IPSAS-IFRS Alignment Dashboard regularly updated by the IPSASB available on https://www.ifac.org/system/files/uploads/IPSASB/Agenda%20Item%201.5%20IPSAS%20IFRS%20Alignment%20Dashboard_June%202019.pdf

recognition date. If borrowing costs are involved, the difference between the cost of the asset and the total payment is recognised as interest over the period of credit or recognised in the carrying amount of the item.'

European Public Good

Assessing whether IPSAS 5 is conducive to the European public good

The assessment of whether IPSAS 5 would be conducive to the European public good addresses the following items:

a) Whether the standard will improve financial reporting;
b) The costs and benefits associated with the standard; and
c) Whether the standard could have an adverse effect to the European economy, including financial stability and economic growth.

These assessments will allow the EU authorities to draw a conclusion as to whether the standard is likely to be conducive to the European public good.

The analysis revealed no reasons why IPSAS 5 would not be conducive to the European public good:

- Measurement and disclosure requirements of IPSAS 5 will provide useful information to the users of the GPFSs and will improve the overall quality of financial reporting in the public sector.
- Implementation of the standard may result in a moderate one-off cost for those governments that elect to capitalise borrowing costs and should be relatively cost-neutral on an ongoing basis for preparers. It will require to manage the difference with ESA 2010 if capitalisation of borrowing costs is chosen.
- Considering its conceptual merits, the standard will bring improved financial reporting when compared to heterogeneous reporting requirements currently applied in the EU. As such, its endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship. The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

Conclusion

Assessing IPSAS 5 against the criteria formulated in the draft EPSAS framework

The analysis has not revealed major conceptual issues with IPSAS 5 'Borrowing Costs' and has not identified any inconsistency between IPSAS 5 and the draft EPSAS framework.

Following the screening analysis summarised in the present report, the future standard setter could consider the following conclusions. The information resulting from the application of IPSAS 5:

- would provide relevant, reliable, complete, prudent, neutral, verifiable, economically substantive, understandable, timely and comparable information needed for making economic decisions and achieving the necessary level of financial transparency and comparability of financial reporting in the European Union;
- would not be contrary to the true and fair view principle; and
- would be conducive to European public good.

However, in order to achieve consistent application of the new standard within the EU context and therefore better address the comparability objective of EPSAS financial statements, additional guidance in certain areas might be desirable.

- *Accounting policy choice for borrowing costs:* The choice of using either the benchmark treatment or allowed alternative treatment creates a potential risk of a lack of comparability between governments that may use different measurement for similar types of borrowing costs. Overall, cost-benefit considerations should guide the choice of a given accounting method versus another. Different users of financial statements may have different views of what these costs or benefits are.

- *Judgment and comparability.* The use of judgment and estimates is inherent in the preparation of financial statements and may to some extent affect the comparability of financial statements.

The analysis has not identified any adverse effect of the standard to the European economy, including financial stability and economic growth, or any other factors that would mean the standard is not conducive to the European public good.

The future standard setter could consider the conclusions of this assessment and likely net benefit of using the requirements of IPSAS 5 as a starting point in developing an equivalent EPSAS standard or recommendation, considering the need for additional guidance in certain areas.