Staff paper

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IASB® meeting

Date	**October 2023**
Project	**Second Comprehensive Review of the *IFRS for SMEs*® Accounting Standard**
Topic	**Recognition of borrowing costs**
Contacts	Edlyn Chigerwe (edlyn.chigerwe@ifrs.org)

Introduction and purpose of the paper

1. The purpose of this paper is to ask the International Accounting Standards Board (IASB) to:

   (a) consider feedback on borrowing costs—a topic that the IASB considered but for which amendments were not proposed in the Exposure Draft *Third edition of the* IFRS for SMEs *Accounting Standard* (Exposure Draft); and

   (b) decide whether to amend the recognition requirements for borrowing costs in the *IFRS for SMEs* Accounting Standard (the Standard).

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Accounting Standard.

Structure of this paper

3. This paper is structured as follows:

   (a) staff recommendation (paragraph 4);

   (b) current requirements for borrowing costs (paragraphs 5–9);

   (c) feedback from the 2020 Request for Information (paragraphs 10–15);

(d) feedback from comment letters (paragraphs 16–17);

(e) staff analysis (paragraphs 18–35);

(f) staff recommendation and question for the IASB (paragraph 36);

(g) Appendix A—extract from the Basis for Conclusions on the *IFRS for SMEs* Accounting Standard; and

(h) Appendix B—illustrative example.

Staff recommendation

4. The staff recommend the IASB retain the recognition requirements for borrowing costs in the *IFRS for SMEs* Accounting Standard.

Background

Current requirements for borrowing costs

5. Section 25 *Borrowing Costs* of the *IFRS for SMEs* Accounting Standard requires SMEs to recognise all borrowing costs as an expense in profit and loss in the period in which they are incurred.

6. IAS 23 *Borrowing Costs* requires borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised as part of the cost of the asset, and all other borrowing costs to be expensed when incurred.

7. The *IFRS for SMEs* Accounting Standard therefore simplifies the requirements in full IFRS Accounting Standards. When developing the *IFRS for SMEs* Accounting Standard, the IASB required SMEs to recognise borrowing costs as an expense for cost-benefit reasons (see paragraph BC120 of the Basis for Conclusions on the Standard).

8. As part of the first comprehensive review of the *IFRS for SMEs* Standard in 2013, the IASB reconsidered the requirement that SMEs recognise all borrowing costs as an expense when incurred, including considering whether to give SMEs an accounting policy option to recognise borrowing costs as part of the cost of a qualifying asset. At that time members of the SME Implementation Group (SMEIG) had mixed views on borrowing costs: a slight majority of members recommended allowing SMEs an option to either expense or recognise borrowing costs as part of the cost of a qualifying asset, a significant minority recommended retaining the requirements in the Standard for cost-benefit reasons and a small minority of members recommended requiring borrowing costs be recognised as part of the cost of a qualifying asset but with an undue cost or effort exemption. At its April 2013 meeting, the IASB tentatively decided not to include an option or requirement for borrowing costs to be capitalised on a similar basis to IAS 23[1]. The IASB reasoned:

   (a) the simplification reduced complexity in calculating the amount of borrowing costs eligible to be recognised as part of the cost of a qualifying asset;

   (b) permitting an accounting policy option to capitalise borrowing costs that meet the criteria for capitalisation in IAS 23 would result in more accounting policy options than full IFRS Accounting Standards; and

   (c) not providing the additional, more complex, accounting policy options would be consistent with its approach for SMEs.

9. The IASB's reasoning is further explained in paragraph BC213–BC214 of the Basis for Conclusions on the Standard (see Appendix A of this paper).

Feedback from the 2020 Request for Information

10. In January 2020, the IASB published Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard* (2020 Request for Information) as a first step in its second comprehensive review of the Standard.

[1] See Agenda Paper 8D Accounting policy options and IASB Update of the April 2013 IASB meeting.

11. Question N4 and Question N5 of the 2020 Request for Information asked respondents to identify any additional issues that they would like to bring to the IASB's attention relating to the *IFRS for SMEs* Accounting Standard.

12. Some respondents to Questions N4 and N5 in the 2020 Request for Information suggested the IASB consider allowing an accounting policy option for borrowing costs to be recognised as part of the cost of a qualifying asset based on similar criteria as in IAS 23.

13. These respondents said borrowing costs are significant for SMEs in certain industries and jurisdictions and not allowing these costs to be recognised as part of the qualifying asset can put these SMEs at a disadvantage.

14. After considering this feedback, most SMEIG members recommended that the IASB take no further action. However, a small number of SMEIG members disagreed and said:

    (a) some SMEs have the resources to calculate the amount of borrowing costs to be recognised as part of the qualifying asset;

    (b) some SMEs will not be able to benefit from applying the IASB's Exposure Draft *Subsidiaries without Public Accountability: Disclosures* as an alternative to the *IFRS for SMEs* Accounting Standard; and

    (c) introducing an accounting policy option to allow borrowing costs to be recognised as part of the cost of a qualifying asset (rather than a requirement) would not add complexity to the Standard.

15. At its November 2021 meeting, the IASB tentatively decided to retain the requirements for borrowing costs and not to seek views in the Exposure Draft on this topic because of the reasons stated in paragraph 8 of this paper.[2]

[2] See Agenda Paper 30E Towards an Exposure Draft—Other topics with no amendments recommended and IASB Update of the November 2021.

Feedback from comment letters

16. The Invitation to Comment in the Exposure Draft included the following question:

Question 11
Do you have any comments on other proposed amendments in the Exposure Draft?

17. Feedback on the recognition of borrowing costs was raised in response to the above question. Some respondents said the IASB should consider introducing either a requirement or an accounting policy option for SMEs to recognise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. These respondents said not allowing SMEs such an option:

    (a) puts SMEs in jurisdictions with high interest rates at a disadvantage;

    (b) makes these SMEs appear less profitable when applying for loans or bidding for contracts (for example, construction contracts) compared to SMEs applying full IFRS Accounting Standards; and

    (c) prevents a faithful representation for SMEs with qualifying assets in their financial statements.

Staff analysis

18. The staff analysis is set out as follows:

    (a) application of the alignment approach (paragraphs 19–21);

    (b) assessment of relevance to SMEs (paragraphs 22–23); and

    (c) assessment of simplicity and cost-benefits — including alternative approaches to addressing feedback on the recognition requirements for borrowing costs for SMEs (paragraphs 24–35).

Application of the alignment approach

19. The IASB's alignment approach treats alignment with full IFRS Accounting Standards as the starting point for developing the *IFRS for SMEs* Accounting Standard, and applies the principles of relevance to SMEs, simplicity and faithful representation, including the assessment of costs and benefits, in determining whether and how that alignment should take place. The IASB applies its alignment approach to each new or revised IFRS Accounting Standard within the scope of the review.

20. As noted in paragraph 14 of September 2023 Agenda Paper 30A *Project Plan*, the staff think the IASB should not plan to re-examine those new and revised IFRS Accounting Standards in the scope of a previous review unless significant implementation issues arise or changes have been made to the related requirements in full IFRS Accounting Standards. The IASB is reviewing the requirements for recognising development costs (see Agenda Paper 30C *Recognition of development costs* of this meeting) and has received concerns from respondents about the requirement to expense borrowing cost that are similar to those concerns received about the requirement to expense development costs. Therefore, the staff think the IASB should review the recognition requirements for borrowing costs.

21. Although IAS 23 is not a new or amended IFRS Accounting Standard in the scope of this review, the staff think the alignment approach could assist the IASB in assessing the feedback and deciding whether to amend the recognition requirements of borrowing costs.

Assessment of relevance to SMEs

22. The IASB determines relevance to SMEs by assessing whether the problem addressed by a new requirement in full IFRS Accounting Standards would make a difference to the decisions of users of financial statements prepared applying the *IFRS for SMEs* Accounting Standard' (see paragraph BC30 of the Basis for Conclusions on the Exposure Draft).

23. Some SMEs may hold qualifying assets and incur significant borrowing costs. This is supported by feedback from the 2020 Request for Information and Exposure Draft which indicated the importance of recognising borrowing costs as part as the cost of a qualifying asset, particularly in jurisdictions experiencing high interest rates. The staff acknowledge that recognising borrowing costs as part of the cost of a qualifying asset that meet specified criteria could make a difference in the decisions of users of these SMEs' financial statements and would be relevant to SMEs. This is because requiring all borrowing costs to be expensed can have a significant impact on profits and net assets for some SMEs (see illustrative example in Appendix B of this paper) which in turn might affect access to financing for SMEs.

Assessment of simplicity and cost-benefits

24. Applying the principle of simplicity involves looking at requirements in full IFRS Accounting Standards that have satisfied the relevance principle and then assessing what simplifications are appropriate for SMEs.

25. Full IFRS Accounting Standards require the recognition of borrowing costs as part of the cost of a qualifying asset (see paragraph 6 of this paper). Costs that do not meet those criteria are recognised as expenses. The *IFRS for SMEs* Accounting Standard simplified the requirements in full IFRS Accounting Standards by requiring SMEs to recognise all borrowing costs as an expense in the period in which they are incurred.

26. The staff are of the view that the possible alternatives to addressing the feedback and simplifying the requirements in IAS 23 are:

    (a) introduce an accounting policy option that permits SMEs to recognise borrowing costs as part of the cost of a qualifying asset that meet the criteria in IAS 23 (see paragraphs 27–30 of this paper);

    (b) require SMEs to recognise borrowing costs as part of the cost of a qualifying asset meeting the criteria in IAS 23 subject to an undue cost or effort exemption (see paragraphs 31–33 of this paper); or

(c) retaining the requirement in the *IFRS for SMEs* Accounting Standard for SMEs to expense borrowing costs (see paragraphs 34–35 of this paper).

Introduce an accounting policy option for borrowing costs

27. Some respondents to the Exposure Draft suggested the *IFRS for SMEs* Accounting Standard could be amended to introduce an accounting policy option enabling SMEs to either recognise borrowing costs as part of the cost of a qualifying asset that meet specified criteria or expense them.

28. The IASB aims to restrict accounting policy options in the Standard because including more complex options generally increases cost for both preparers and users of SMEs financial statements; increases complexity and also reduce comparability. Paragraphs BC208–BC209 of the Basis for Conclusions on the Standard explain the IASB's reasons for restricting accounting policy options.

29. Nevertheless, in limited cases, the IASB includes accounting policy options in the Standard applying the simplification principle. For example, the cost model, the equity method or the fair value model is permitted for accounting for investments in associates. The IASB could consider introducing an option for SMEs to recognise borrowing costs as part of the cost of a qualifying asset if it considers this to be an appropriate application of the simplification and faithful representation principles.

30. The staff think that permitting an SME an accounting policy option to recognise borrowing costs as part of the cost of a qualifying asset meeting the criteria in IAS 23 would:

(a) enable those SMEs that have significant borrowing costs (such as those in jurisdictions with high interest rates) and the capability to perform the required calculations to recognise borrowing costs meeting the criteria in IAS 23 as part of the cost of a qualifying asset;

(b) enable other SMEs to expense borrowing costs as incurred; and

(c) enable SMEs to balance the cost-benefit of an accounting policy option for borrowing costs without imposing excessive burden on all SMEs.

Nevertheless, the staff question whether permitting SMEs an accounting policy to recognise borrowing costs as part of the cost of a qualifying asset would provide benefits to users. This is considered further in paragraph 35 of this paper.

Require recognition of borrowing costs with an undue cost or effort exemption

31. As the IASB aims to limit accounting policy options, the IASB could instead require borrowing costs be recognised as part of the cost of a qualifying asset unless doing so results in undue cost or effort. Introducing an undue cost of effort exemption would result in two possible outcomes:

(a) if an SME can obtain or determine the information necessary to recognise borrowing costs as part of the cost of a qualifying asset without undue cost or effort, the SME would be required to recognise borrowing costs applying the same criteria as in IAS 23; and

(b) if not, the SME would expense borrowing costs when incurred as required by paragraph 25.2 of the Standard.

32. As per paragraph 2.14B of the Standard, an undue cost or effort exemption is dependent on each SME’s specific circumstances and management’s judgement of the costs and benefits of applying the requirement.

33. The staff are of the view that aligning the recognition requirements for borrowing costs in the Standard with IAS 23 and providing an undue cost or effort exemption may be burdensome for SMEs. In particular, the benefit of an undue cost or effort exemption may be limited as the SME would still need to assess whether it meets the exemption when applying the requirements.

Retain the requirement to expense borrowing costs

34. The staff think that the requirements to recognise borrowing costs applying IAS 23 would be onerous for most SMEs, particularly determining whether the borrowing costs meet the criteria for recognition as part of the cost of a qualifying asset and calculating the amount of borrowing costs eligible to be recognised as part of the cost of a qualifying asset. For most SMEs, permitting borrowing costs to be recognised as part of the cost of a qualifying asset would increase costs without adding significant benefit to users of their financial statements. For example, recognising borrowing costs as part of the cost of a qualifying asset does not provide lenders with information about the SME's cash flows and obligations (see BC157 of Basis for Conclusions on the Standard).

35. The requirement to expense all borrowing costs was made because of cost-benefit reasons. The staff think retaining the Standard's requirements would minimise costs of preparing financial statements for SMEs and maintain the simple application of the Standard. Furthermore, the staff think retaining the requirement to expense all borrowing costs thereby including all borrowing costs in one place in the statement of financial performance makes it easier for users of SMEs' financial statements to assess an SMEs' cost of debt and forecast cashflows. To this end, the staff think the current requirements provide greater transparency and more useful information for less sophisticated users of SMEs' financial statements than recognising some borrowing costs as part of the cost of a qualifying asset. This is supported by feedback from user surveys and user interviews on the 2020 Request for Information that indicated that the IASB should consider transparency in assessing the benefits to users of SMEs' financial statements[3].

[3] See slide 28 of the 2020 Request for Information user survey and user interview feedback summary, discussed at the February 2021 SME Implementation Group (SMEIG) meeting.

Staff recommendation and question for the IASB

36. The staff recommend the IASB retain the recognition requirements for borrowing costs in the *IFRS for SMEs* Accounting Standard.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 36 of this paper to retain the recognition requirements for borrowing costs in the *IFRS for SMEs* Accounting Standard?

Appendix A—extract from the Basis for Conclusions on the *IFRS for SMEs* Accounting Standard

A1.1 The following extract summarises the considerations of the IASB during the first comprehensive review of the *IFRS for SMEs* Accounting Standard when reviewing the recognition requirements for borrowing costs.

Capitalisation of development or borrowing costs

BC213 Only a small number of respondents to the RFI and the 2013 ED supported a requirement for SMEs to capitalise development and/or borrowing costs based on similar criteria to full IFRS. However, several respondents supported giving SMEs an option to capitalise development and borrowing costs based on similar criteria to full IFRS. They supported introducing this option for reasons similar to those expressed by respondents in paragraph BC210, ie the effect on current and future borrowing arrangements and high-inflation environments. However, many respondents did not support changing the current requirements and would continue to require SMEs to expense all development and borrowing costs.

BC214 The *IFRS for SMEs* requires all borrowing and development costs to be recognised as expenses. Full IFRS requires the capitalisation of borrowing and development costs meeting certain criteria; otherwise they are recognised as expenses. Consequently, the *IFRS for SMEs* simplifies the requirements in full IFRS, instead of removing an option permitted in full IFRS. The IASB therefore noted that allowing options to capitalise certain development and borrowing costs would involve different considerations than allowing a revaluation option for property, plant and equipment. In particular the IASB observed that permitting accounting policy options to capitalise development and borrowing costs that meet the criteria for capitalisation in IAS 38/IAS 23, in addition to the current approach, would result in more accounting policy options than full IFRS. The IASB noted that it continues to support its rationale for requiring the recognition of all development and borrowing costs as expenses, for cost-benefit reasons as set out in paragraphs BC113–BC114 and BC120, and for not providing the additional, more complex, accounting policy options for SMEs as set out in paragraphs BC208–BC209. The IASB noted that an SME should disclose additional information about its borrowing or development costs if it is considered relevant to users of its financial statements.

Appendix B—illustrative example

In Scenario A, the SME recognises borrowing costs as an expense in profit or loss in the period in which they are incurred, consistent with Section 25 *Borrowing Costs* of the *IFRS for SMEs* Accounting Standard.

In Scenario B, the SME capitalises borrowing costs that are directly attributable to the construction of a qualifying asset as part of the cost of the asset. This is consistent with IAS 23 *Borrowing Costs*.

On 1 January 20X1, an SME took out a CU300,000 loan specifically for the purpose of constructing manufacturing equipment. The loan bears interest at the fixed rate of 10% per year. The entity is required to pay only the interest on the loan for five years. The principal is repaid as a lump sum at the end of the fifth year.

Construction of the manufacturing equipment begins on 1 January 20X1 and is completed on 31 December 20X3.

Loan	***300,000***
Repayment period	***5***
Interest	***10%***

	Scenario A:	**Scenario B:**	
	Borrowing costs expensed	**Borrowing costs capitalised**	**Difference**
Year ending 31 December 20X1	**CU**	**CU**	**CU**
Statement of financial position (extract)			
Equipment - Construction in progress	100,000	100,000	
Equipment - Borrowing costs	-	30,000	
Total non-current assets	**100,000**	**130,000**	**30,000**

Statement of comprehensive income (extract)			
Revenue	-	-	
Finance costs	(30,000)	-	
Profit/(loss) for the year	**(30,000)**	**-**	**30,000**

Year ended 31 December 20X2	**CU**	**CU**	**CU**
Statement of financial position (extract)			
Equipment - Construction in progress	200,000	200,000	
Equipment - Borrowing costs	-	60,000	
Total non-current assets	**200,000**	**260,000**	**60,000**
Statement of comprehensive income (extract)			
Revenue	-	-	
Finance costs	(30,000)	-	
Profit/(loss) for the year	**(30,000)**	**-**	**30,000**

Year ended 31 December 20X3	**CU**	**CU**	**CU**
Statement of financial position (extract)			
Equipment - Construction in Progress	300,000	300,000	
Equipment - Borrowing costs	-	90,000	
Total non-current assets	**300,000**	**390,000**	**90,000**
Statement of comprehensive income (extract)			
Revenue	-	-	
Finance costs	(30,000)	-	
Profit/(loss) for the year	**(30,000)**	**-**	**30,000**

On 1 January 20X4, the SME uses the manufacturing equipment.

The SME depreciates the equipment on the straight-line method over 20 years to a nil residual value.

Year ended 31 December 20X4	CU		CU		CU
Statement of financial position (extract)					
Equipment - cost	300,000		390,000		
Accumulated depreciation	(15,000)	*	(19,500)	**	
Carrying amount	**285,000**		**370,500**		**85,500**
Statement of comprehensive income (extract)					
Revenue	150,000		150,000		
Raw material and consumables used	(100,000)		(100,000)		
Finance costs	(30,000)		(30,000)		
Depreciation	(15,000)	*	(19,500)	**	
Profit/(loss) for the year	**5,000**		**500**		**(4,500)**

Notes:

* CU300,000 cost ÷ 20 years useful life = CU15,000 depreciation charge for the year

** CU390,000 cost ÷ 20 years useful life = CU19,500 depreciation charge for the year