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IFRS Foundation: Training Material for the *IFRS*® *for SMEs*

Module 25 – Borrowing Costs

IFRS™

IFRS Foundation: Training Material for the *IFRS® for SMEs*

including the full text of
Section 25 *Borrowing Costs*
of the International Financial Reporting Standard (IFRS)
for Small and Medium-sized Entities (SMEs)
issued by the International Accounting Standards Board on 9 July 2009

with extensive explanations, self-assessment questions and case studies

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Module 25 – Borrowing Costs

This training material has been prepared by IFRS Foundation education staff and has not been approved by the International Accounting Standards Board (IASB). The accounting requirements applicable to small and medium-sized entities (SMEs) are set out in the *International Financial Reporting Standard (IFRS) for SMEs*, which was issued by the IASB in July 2009.

INTRODUCTION

This module focuses on the accounting and reporting of borrowing costs in accordance with Section 25 *Borrowing Costs* of the *International Financial Reporting Standard (IFRS) for Small and Medium-sized Entities (SMEs)*. It introduces the learner to the subject, guides the learner through the official text, develops the learner's understanding of the requirements through the use of examples and indicates significant judgements that are required in accounting for borrowing costs. Furthermore, the module includes questions designed to test the learner's knowledge of the requirements and a case study to develop the learner's ability to account for borrowing costs in accordance with the *IFRS for SMEs*.

Learning objectives

Upon successful completion of this module you should know the requirements for accounting and reporting borrowing costs in accordance with the *IFRS for SMEs*. Furthermore, through the completion of the case study that simulates aspects of the real world application of that knowledge, you should have enhanced your ability to account for and present financial statements in accordance with the *IFRS for SMEs*. In particular you should, in the context of the *IFRS for SMEs*: be able

- to distinguish borrowing costs from other costs
- to disclose borrowing costs in financial statements
- to demonstrate an understanding of the significant judgements that are required in accounting for borrowing costs.

Module 25 – Borrowing Costs

IFRS for SMEs

The *IFRS for SMEs* is intended to apply to the general purpose financial statements of entities that do not have public accountability (see Section 1 *Small and Medium-sized Entities*).

The *IFRS for SMEs* includes mandatory requirements and other material (non-mandatory) that is published with it.

The material that is not mandatory includes:

- a preface, which provides a general introduction to the *IFRS for SMEs* and explains its purpose, structure and authority.
- implementation guidance, which includes illustrative financial statements and a disclosure checklist.
- the Basis for Conclusions, which summarises the IASB's main considerations in reaching its conclusions in the *IFRS for SMEs*.
- the dissenting opinion of an IASB member who did not agree with the publication of the *IFRS for SMEs*.

In the *IFRS for SMEs* the Glossary is part of the mandatory requirements.

In the *IFRS for SMEs* there are appendices in Section 21 *Provisions and Contingencies*, Section 22 *Liabilities and Equity* and Section 23 *Revenue.* Those appendices are non-mandatory guidance.

Introduction to the requirements

The objective of general purpose financial statements of a small or medium-sized entity is to provide information about the financial position, financial performance and cash flows of the entity that is useful for economic decision-making by a broad range of users who are not in a position to demand reports tailored to meet their particular information needs.

The objective of Section 25 is to prescribe the accounting for borrowing costs. Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. This section requires an entity to recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred. Other sections also specify requirements for the accounting and reporting of borrowing costs (eg Section 11 *Basic Financial Instruments* for interest expense calculated using the effective interest rate method and Section 20 *Leases* for finance charges in respect of finance leases).

Module 25 – Borrowing Costs

REQUIREMENTS AND EXAMPLES

The contents of Section 25 *Borrowing Costs* of the *IFRS for SMEs* are set out below and shaded grey. Terms defined in the Glossary of the *IFRS for SMEs* are also part of the requirements. They are in **bold type** the first time they appear in the text of Section 25. The notes and examples inserted by the IFRS Foundation education staff are not shaded. The insertions made by the staff do not form part of the *IFRS for SMEs* and have not been approved by the IASB.

Scope of this section

25.1 This section specifies the accounting for **borrowing costs**. Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. Borrowing costs include:

(a) interest expense calculated using the effective interest method as described in Section 11 *Basic Financial Instruments*.

(b) finance charges in respect of finance leases recognised in accordance with Section 20 *Leases*.

(c) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

Notes

The exchange difference component of borrowing costs arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs is not a major issue in the *IFRS for SMEs* as both borrowing costs and exchange differences are recognised as an expense.

Examples 25.1 – borrowing costs

Ex 1 **An entity incurs interest at the fixed rate of 5 per cent per year on a CU100,000[(1)] loan from a local bank.**

The 5 per cent interest on the loan is a borrowing cost.

Ex 2 **An entity issued a CU100,000 debenture to a local bank. The debenture contract requires the entity, on the sixth anniversary of the loan, to pay the local bank CU134,010 to redeem the debenture (ie CU100,000 repayment of capital and CU34,010 premium). The debenture has a coupon of zero (ie it is ‘interest-free’).**

The amortisation of the redemption premium is a borrowing cost. In accordance with Section 11 *Basic Financial Instruments* the entity accounts for the debenture at amortised cost. Amortised cost requires accrual of the CU34,010 premium to be recognised over the life of the debenture using the effective interest method.

[(1)] In this example, and in all other examples in this module, monetary amounts are denominated in ‘currency units (CU)’.

Using a spreadsheet or financial calculator, the effective interest rate on this debenture is calculated at 5 per cent (ie the present value of a single payment of CU134,010 at the end of six years at 5 per cent is CU100,000) (Calculation: CU100,000 × (1+r)^6 = CU134,010).

The premium of CU34,010 would be amortised as follows:

Year	Amortisation of premium (5% × liability)	Liability	Premium
		CU100,000	CU34,010
1	CU5,000	105,000	29,010
2	5,250	110,250	23,760
3	5,513	115,763	18,247
4	5,788	121,551	12,459
5	6,078	127,629	6,381
6	6,381	134,010	0

Ex 3 **An entity incurred CU1,000 legal fees to raise a CU100,000 loan that bears interest at the fixed rate of 5 per cent per year. The principal of the loan is repayable on the sixth anniversary of the loan.**

The interest on the loan is a borrowing cost. Furthermore, the amortisation of the legal fees (ancillary cost incurred to arrange the borrowing) is a borrowing cost. In accordance with Section 11 the entity accounts for the loan at amortised cost. Amortised cost requires the CU1,000 transaction costs be included in the initial measurement of the liability and recognised over the life of the loan using the effective interest method.

Ex 4 **An entity entered, as lessee, into a finance lease over an item of equipment. In accordance with paragraph 20.9 at the commencement of the lease term the entity recognised a CU100,000 asset and a CU100,000 liability. The entity incurred CU5,000 costs to negotiate and arrange the lease. The entity apportioned the minimum lease payments, in accordance with paragraph 20.11, between the finance charge and the reduction of the outstanding liability.**

The finance charge is a borrowing cost.

The CU5,000 costs to negotiate and arrange the lease are an initial direct cost of the lessee. In accordance with paragraph 20.9, such costs are added to the amount recognised as an asset. The effect of adding initial direct costs to the carrying amount of the asset (and hence increasing the carrying amount by CU5,000) will be to increase, by CU5,000, the total amount of depreciation recognised over the shorter of the lease term and the asset's useful life.

Ex 5 **An entity incurs interest at the fixed rate of 2 per cent per year on a FCU100,000[2] loan from a foreign bank that is repayable in full on the sixth anniversary of the loan. The functional currency of the entity is the currency unit (CU). The entity borrowed money in a foreign currency (FCU) because it believed that after taking account of the expected foreign exchange loss attributed to the inflation differential between the CU and the FCU, the effective interest rate on the FCU denominated loan would be 4 per cent per year when equivalent local CU denominated loans bear interest at 5 per cent per year. Changes in the CU/FCU exchange rate and the domestic inflation index proved to be consistent with the entity's predictions.**

The exchange losses and the interest on the liability are borrowing costs. The sum of the exchange losses and the interest for the reporting period are less than what the interest would have been on an equivalent CU denominated loan for the reporting period.

Ex 6 **The facts are the same as in example 5. However, in this example, assume that the foreign exchange losses and interest on the FCU denominated loan exceeded the amount that interest expense would have been had the entity borrowed in its functional currency (the CU).**

The entity accounting policy for borrowing costs on foreign currency denominated loans limits total borrowing cost (interest and exchange differences on the principal) to a theoretical borrowing cost based on what the interest would have been on an equivalent CU denominated loan for the reporting period. The excess exchange loss, if any, is classified as a foreign exchange loss.

The amount of the exchange loss that can be accounted for as a borrowing cost is limited in accordance with the entity's accounting policy that implements the requirements of paragraph 25.1(c). The limitation is such that the total borrowing cost (interest and exchange differences on the principal) does not exceed a theoretical borrowing cost based on what the interest would have been on an equivalent CU denominated loan for the reporting period.[3] The excess exchange loss, if any, is classified as a foreign exchange loss.

Recognition

25.2 An entity shall recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred.

Examples 25.2 – recognition

Ex 7 **On 1 January 20X1 an entity borrowed CU100,000 from a local bank. The bank charges interest on the loan at the fixed rate of 5 per cent per year. Interest is payable annually in arrears (ie on 31 December each year). The principal (CU100,000) is repayable in full on the sixth anniversary of the loan.**

[2] In this example, and all other examples in this module, foreign currency monetary amounts are denominated in 'foreign currency units (FCU)'.

[3] Other methods of implementing the requirements of paragraph 25.1(c) may also be acceptable.

The entity must recognise CU5,000 interest (borrowing cost) as an expense in the determination of profit or loss for each of the years ended 31 December 20X1 to 31 December 20X6.

Ex 8 **On 1 July 20X1 an entity borrowed CU100,000 from a local bank. The bank charges interest on the loan at the fixed rate of 5 per cent per year. Interest is payable annually in arrears (ie on 30 June each year). The principal (CU100,000) is repayable in full on the sixth anniversary of the loan. The entity's annual reporting period ends on 31 December.**

The entity must recognise CU2,500 interest (borrowing cost) as an expense in the determination of profit or loss for each of the years ended 31 December 20X1 and 31 December 20X7 (ie interest accrues for the six months that the loan is in existence in each of those years).

The entity must recognise CU5,000 interest (borrowing cost) as an expense in the determination of profit or loss for each of the years ended 31 December 20X2 to 31 December 20X6.

Ex 9 **On 1 January 20X1 an entity issued a CU100,000 debenture to a local bank. The debenture contract requires the entity pay the local bank CU110,250 to redeem the debenture on 31 December 20X2. The debenture has a coupon of zero (ie it is 'interest-free').**

The entity must recognise CU5,000 and CU5,250 borrowing costs respectively as an expense in the determination of profit or loss for the years ended 31 December 20X1 and 31 December 20X2. The borrowing cost is the amortisation of the redemption premium calculated using the effective interest method (Section 11 deals with the application of the effective interest method) (Calculation: CU100,000 × (1+r)^2 = CU110,250).

Ex 10 **On 1 January 20X1 an entity incurred CU5,000 transaction costs to raise a CU100,000 loan that bears interest at the fixed rate of CU5,000 (or 5 per cent) per year. Interest is payable yearly in arrears (ie on 31 December each year). The principal of CU100,000 is repayable in full on the second anniversary of the loan.**

The entity must recognise CU7,406[(a)] and CU7,594[(c)] borrowing costs respectively as an expense in the determination of profit or loss for the years ended 31 December 20X1 and 31 December 20X2. The borrowing cost includes the transaction costs and the interest calculated using the effective interest method in accordance with Section 11.

(a) CU95,000[(b)] × 7.796%[(e)] = CU7,406 finance cost for the year ended 31 December 20X1

(b) CU100,000 loan proceeds less CU5,000 transaction costs = CU95,000 liability at 1 January 20X1

(c) CU97,406[(d)] × 7.796%[(e)] = CU7,594 finance cost for the year ended 31 December 20X2

(d) CU95,000[(b)] + CU7,406[(a)] less CU5,000 payment = CU97,406 liability at 31 December 20X1

(e) The effective interest rate is 7.796 per cent per year, which can be determined using a calculator as follows: n=2, PV=-CU95,000, FV=CU100,000, PMT=CU5,000.

Disclosures

25.3 Paragraph 5.5(b) requires disclosure of finance costs. Paragraph 11.48(b) requires disclosure of total interest expense (using the effective interest method) for financial liabilities that are not at fair value through profit or loss. This section does not require any additional disclosure.

SIGNIFICANT ESTIMATES AND OTHER JUDGEMENTS

Applying the requirements of the *IFRS for SMEs* to transactions and events often requires judgement. Information about significant judgements and key sources of estimation uncertainty are useful in assessing the financial position, performance and cash flows of an entity.

Consequently, in accordance with paragraph 8.6, an entity must disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Furthermore, in accordance with paragraph 8.7, an entity must disclose information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

Other sections of the *IFRS for SMEs* require disclosure of information about particular judgements and estimation uncertainties.

Recognition and measurement

Borrowing costs (finance costs) are measured in accordance with other sections of the *IFRS for SMEs* (eg Section 11 *Basic Financial Instruments* and Section 20 *Leases*). Section 25 adds no further judgements.

Module 25 – Borrowing Costs

COMPARISON WITH FULL IFRSs

The following are the primary differences between the requirements as issued at 9 July 2009 for accounting for borrowing costs in accordance with IAS 23 *Borrowing Costs* and the *IFRS for Small and Medium-sized Entities* (see Section 25 *Borrowing costs*).

IAS 23 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. For cost-benefit reasons, Section 25 of the *IFRS for SMEs* requires such costs to be charged to expense.

The composition of borrowing costs in full IFRSs (see paragraph 6 of IAS 23) and the *IFRS for SMEs* (see paragraph 25.1) are similar. However, differences between borrowing costs as defined in IAS 23 and Section 25 may arise because the requirements for the calculation of the underlying 'finance costs' may be different. For example, interest expense calculated in accordance with Section 11 *Basic Financial Instruments* of the *IFRS for SMEs* might differ from 'finance cost' calculated on the same instrument in accordance with full IFRSs (ie IAS 39 *Financial Instruments: Recognition and Measurement*).

Module 25 – Borrowing Costs

TEST YOUR KNOWLEDGE

Test your knowledge of the requirements for accounting for borrowing costs in accordance with the *IFRS for SMEs* by answering the questions below.

Once you have completed the test check your answers against those set out below this test.

Assume all amounts are material.

Mark the box next to the most correct statement.

Question 1

Borrowing costs are:

☐ (a) interest and other costs that an entity incurs in connection with the borrowing of funds.

☐ (b) interest expense calculated using the effective interest method as described in Section 11 *Basic Financial Instruments* only.

☐ (c) finance charges in respect of finance leases recognised in accordance with Section 20 *Leases* only.

☐ (d) none of the above.

Question 2

Borrowing costs do not include:

☐ (a) interest incurred on bank overdrafts.

☐ (b) incremental administrative fees incurred in connection with raising loans.

☐ (c) finance charges in respect of finance leases recognised in accordance with Section 20 *Leases*.

☐ (d) dividends declared to equity holders.

Question 3

An entity must:

☐ (a) recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred.

☐ (b) recognise all borrowing costs as an expense in profit or loss in the period in which they are incurred, except to the extent that borrowing costs that are directly attributable to the acquisition, construction or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale are capitalised as part of the cost of that asset.

☐ (c) choose either (a) or (b) above as its accounting policy for borrowing costs and apply the chosen policy consistently to all of its borrowing costs.

Module 25 – Borrowing Costs

Answers

Q1 (a) see paragraph 25.1
Q2 (d) see paragraph 25.1
Q3 (a) see paragraph 25.3

Module 25 – Borrowing Costs

APPLY YOUR KNOWLEDGE

Apply your knowledge of the requirements of accounting for borrowing costs in accordance with the *IFRS for SMEs* by solving the case study below.

Once you have completed the case study check your answer against that set out at the bottom of this test.

Case study

On 1 January 20X1 SME A took out a loan of FCU150,000 from a foreign bank, which was equal to CU300,000 on that date. The *FCU denominated* loan is repayable on 31 December 20X9 and bears interest at the fixed rate of 2 per cent per year. Interest is payable yearly in arrears (ie on 31 December each year) in the period the loan is outstanding. The entity borrowed in a foreign currency because it believed that after taking account of the expected foreign exchange loss attributed to the inflation differential between the CU and the FCU, the effective interest rate on the FCU denominated loan would be approximately 4 per cent per year, in comparison with 5 per cent per year on a equivalent local CU denominated loan. Changes in the CU/FCU exchange rate and the domestic inflation index proved to be consistent with the entity's predictions.

On 1 January 20X1 SME A incurred and paid CU5,000 transaction costs in borrowing CU200,000 from Bank Z. The *CU denominated* fixed-rate loan bears interest at 5 per cent per year (compounded annually). Both the principal and the accrued interest must be settled on 31 December 20X5.

On 31 March 20X1 SME A issued a *debenture* with a face value of CU100,000 to Bank Y for CU90,000 (ie the debenture was issued at a CU10,000 discount). The debenture is interest-free. However, on 1 April 20X4, SME A must pay Bank Y CU105,000 to redeem the debenture (ie the debenture must be redeemed at a CU5,000 premium).

On 30 June 20X1 SME A entered, as lessee, into a *finance lease* over an item of equipment.
To recognise the rights and obligations in the lease SME A recognised a CU100,000 asset and a CU100,000 liability. The interest rate implicit in the lease is 5 per cent per year.
Lease payments are made annually in arrears.

On 31 August 20X1, SME A entered, as lessee, into an *operating lease* over an item of equipment. In accordance with the lease agreement SME A paid CU1,000 per month for the right to use the item of equipment from 1 September 20X1 to 31 January 20X2.

SME A's functional currency is the currency unit (CU). At 31 December 20X1 the exchange rate was CU2.04:FCU1.

Prepare accounting entries to record the liabilities and borrowing costs in the accounting records of SME A for the year ended 31 December 20X1.

Answer to case study

1 January 20X1

Dr Cash	CU300,000	
Cr Financial liability		CU300,000

To recognise the FCU denominated long-term financial liability.

Dr Financial liability	CU5,000	
Cr Cash		CU5,000

To recognise transaction costs in raising the CU denominated long-term financial liability.

Dr Cash	CU200,000	
Cr Financial liability		CU200,000

To recognise the CU denominated long-term financial liability.

31 March 20X1

Dr Cash	CU90,000	
Cr Financial liability		CU90,000

To recognise the CU100,000 (debenture) long-term financial liability issued at a discount of CU10,000 (see Section 11 Basic Financial Instruments*).*

30 June 20X1

Dr Property, plant and equipment (leases equipment)	CU100,000	
Cr Financial liability		CU100,000

To recognise the asset (leased equipment) and long-term financial liability arising from the finance lease.

31 December 20X1

Dr Profit or loss (borrowing cost—interest and exchange loss on accrued interest)	CU6,120[(a)]	
Cr Cash		CU6,120

To recognise settlement of interest and the foreign exchange loss on the accrued interest, on the FCU denominated financial liability.

Dr Profit or loss (borrowing cost—exchange loss)	CU6,000[(b)]	
Cr Financial liability		CU6,000

To recognise the exchange loss on the FCU denominated long-term financial liability regarded as an adjustment to interest costs.

Dr	Profit or loss (borrowing costs—interest and transaction costs)	CU10,789[(d)]	
	Cr Financial liability		CU10,789

To recognise finance costs (interest and transaction costs) on the CU denominated long-term financial liability.

Dr	Profit or loss (borrowing costs—discount on issue and premium on redemption)	CU3,559[(g)]	
	Cr Financial liability		CU3,559

To recognise finance costs on the long-term financial liability—debenture.

Dr	Profit or loss (borrowing costs—finance cost)	CU2,500[(i)]	
	Cr Financial liability (current liability)		CU2,500

To recognise finance costs on the lease liability.

The entity would also recognise the operating lease rental (which is not a borrowing cost) as follows:

Dr	Profit or loss (operating lease costs)	CU4,000[(j)]	
	Cr Cash		CU4,000

To recognise operating lease payments (not a borrowing cost).

The calculations and explanatory notes below do not form part of the answer to this case study:

(a) FCU150,000 × 2% interest × 2.04 exchange rate = CU6,120 interest and foreign exchange loss

(b) CU306,000[(c)] less CU300,000 carrying amount of the FCU denominated loan at 1 January 20X1 = CU6,000 exchange loss

(c) FCU150,000 × 2.04 exchange rate = CU306,000 carrying amount of the FCU150,000 loan at 31 December 20X1

(d) CU195,000[(e)] × 5.533% effective interest rate[(f)] = CU10,789 finance cost—interest and transaction costs

(e) CU200,000 loan less CU5,000 transaction costs = CU195,000 carrying amount at 2 January 20X1

(f) The effective interest rate of 5.533% was computed using a financial calculator
It could also be determined as follows:
CU200,000 × 1.05^5 = CU255,256.3, which equals the sum of the principal and compounded interest due at the end of 5 years
The rate that discounts the CU255,256.3 back to the initial carrying amount of CU195,000 is 5.533%, which is determined as follows: (CU255,256.3/CU195,000)^[1/5]-1

(g) CU90,000 proceeds on issue × 5.273% effective interest rate[(h)] × 9/12 months (ie 1 April to 31 December) = CU3,559 finance cost—discount on issue and premium on redemption (effective interest rate)

(h) The effective interest rate of 5.273% is computed using a financial calculator or spreadsheet

(i) CU100,000 liability × 5% interest rate implicit in the lease x 6/12 months (ie 1 July to 31 December) = CU2,500 finance cost

(j) 4 months (ie 1 September to 31 December) × CU1,000 operating lease payments = CU4,000 operating lease expense (note—operating lease expense is not a borrowing cost)