EFRAG

European Financial Reporting Advisory Group

16 November 2006

IAS 23 Amendments
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir/Madam

Re: Exposure Draft of Proposed Amendments to IAS 23 *Borrowing Costs*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft of Proposed Amendments to IAS 23 *Borrowing Costs*. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issue.

Firstly we would like to re-emphasise the fact that we support the IFRS/US GAAP convergence project, although we do not believe it appropriate to pursue convergence regardless of the cost. However, after having studied the proposals we have two concerns:

1 Although the effect of the proposals if implemented will be that companies reporting under IFRS will, like companies reporting under US GAAP, be required to capitalise any borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset, the amounts that will be capitalised will continue to be different (because the proposals address only one of the differences between IFRS and US GAAP and do not, for example, address the differences that exist as to the composition of the costs and the calculation techniques).

2 The objective of an IASB/FASB short-term convergence project is to converge around whichever is considered to be the better of the two sets of requirements. Although that is an appropriate objective for a short-term convergence project, we are not wholly convinced that the existing approach to the capitalisation of actual borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is preferable to immediate expensing. We would have preferred a more comprehensive review of the strengths and weaknesses of each approach to be undertaken before a conclusion on the matter was reached.

For those reasons, EFRAG questions the wisdom of making the changes proposed in the Exposure Draft.

Companies that wish to adopt the US practice of capitalising borrowing costs are already able to do so under existing IFRS, so the proposals are of little benefit to them—although we understand, based on a comment that was made by IASB representatives to an EFRAG delegation at our public meeting on convergence on 17 October, that the proposal might result in the elimination of the US SEC's reconciliation requirement for borrowing costs for such companies.

Nor are the proposed changes of any benefit to companies wishing to continue expensing borrowing costs—instead, the proposed changes are likely to be perceived as an added burden. That is because, although eliminating options in accounting standards ought to help simplify the accounting requirements thereby making things easier for users; in this case so little convergence is achieved—and the differences that remain are sufficiently important—that we doubt that the proposed change will benefit users to any noticeable extent. The questions that we believe remain about this particular capitalisation approach –see earlier comment – mean we believe that the benefits of a more complete implementation of the cost accrual model may also be minimal.

Our detailed answers to the questions are stated in the attached note.

If you would like further clarification of the points raised in this letter, Nasreen Vadachia or I would be happy to discuss these further with you.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Question 1

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

We recognise that the change proposed by this ED is introduced as part of the convergence with US GAAP and is understood by the IASB to achieve sufficient convergence to result in the elimination of the reconciliation requirement in relation to the recognition of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. We accept that such amendments represent a step in the direction of full convergence, thereby enabling one of the targets set by the roadmap to be met. We also accept that, in principle, the proposed change may result in a more complete implementation of the cost-accruals model.

Notwithstanding the above, we are concerned that the proposals will result in less than full alignment of the accounting. Various inconsistencies (most significantly composition of the costs under consideration and the calculation techniques) will continue to exist thus resulting in the amounts capitalised under IFRS and US GAAP being different. We therefore question the usefulness of the proposed change in light of the fact that preparers already have an option of capitalisation, therefore those wishing to achieve the degree of convergence with US GAAP that the proposed amendment achieves can simply follow this option.

The IASB has stated that the objective, where a short-term convergence project is involved, is to converge around whichever is considered to be the better of IFRS and US GAAP. We accept that, if one is adopting a cost-based accruals (or probably even a mixed measurement-based) approach, it would seem logical to capitalise expenses directly attributable to the acquisition, construction or production of a capitalised asset. However, EFRAG believes that there are a number of related issues—including the attribution of borrowing costs to assets, and the inconsistencies that arise between standards—that it would be preferable to consider further and address appropriately before reaching a conclusion as to whether the capitalisation approach proposed more appropriately meets the objectives of financial reporting than immediate expensing.

On a practical level, the implementation of capitalization of borrowing costs implies quite sophisticated information systems. Within a group, implementing the method in a consistent manner already implies costly and lengthy consolidation adjustments, the financing structures of subsidiaries and the parent being often different and intra group loans having to be eliminated on consolidation. The amendment might require from entities listed both in the US and Europe to carry up to 3 different sets of carrying amounts for qualifying assets in order to prepare consolidated and individual financial statements in conformity with IFRS. Therefore, the proposed amendment creates an administrative burden with no added value for the preparers, and affects all IFRS compliant entities in Europe although the change is aimed at benefiting only a small number of them.

The IASB indicates (in its basis for conclusions) that neither set of specific provisions (of IAS23 and SFAS34) may be regarded as being of a clearly higher quality than the other. It presumably follows that the proposed amendment is not intended to stay in the long-run. Nonetheless capitalisation of borrowing costs demands a costly implementation exercise that may not meet the cost/benefit analysis, especially if it is not meant to last.

In the Basis of Conclusions (BC 10) of the Exposure Draft, one of the arguments in favour of the capitalisation of borrowing costs is that it "enhances comparability between assets that are internally developed and those acquired from third parties." However, all other things being equal the amount capitalised will still be different because a profit margin is not usually included in the cost of internally developed assets. This suggests either that the comparability argument is not really appropriate or that the IASB has an elaborated understanding as to what comparability involves when the transactions are different—in which case it would be useful to explain that understanding for wider debate.

Regardless of convergence, we generally favour elimination of options in accounting standards, not least because it usually results in users benefiting from a simplified accounting framework. However, although these proposals eliminate an option, we doubt that they will benefit users to any noticeable degree because the differences between IFRS and US GAAP mean that, for example, the amounts capitalised will differ.

For these reasons we question the wisdom of making the proposed changes in the ED, until such time that it can demonstrated that the IASB's reasons for the proposed change are based on a thorough analysis of the pros and cons of the different approaches.

Question 2

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

While we generally favour retrospective application, in this instance we concur with the Board's assessment that the cost of retrospective application would outweigh the benefits. We also understand and agree with the Board's rationale for allowing entities to apply the amendment from any date before the effective date. Therefore, we support the proposed transitional provisions should the Board decide to continue the project which we are opposed to as described above.