Problems with Accounting of Borrowing Costs Capitalized in Compliance with the IFRS and the Ways to Solve them

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ABSTRACT

Preparing the data that meets the requirements of International Financial Reporting Standards is considered urgent for every economic entity and an investor seeking opportunities to invest. This article is devoted to the study of the theoretical and practical issues related to borrowing costs capitalized in compliance with International Financial Reporting Standards, the cases in which borrowing costs are recognized as an asset, and the problems and solutions of their accounting and reflection in the reporting.

CCS CONCEPTS

• **loans**; • **borrowings**; • **assets**; • **capitalized costs**; • **average interest**; • **IFRS.**;

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1 INTRODUCTION

The processes of globalization of the economy are characterized by fundamental changes in economic relations between countries, financial systems and mechanisms, business rules. One of the factors significantly restraining the development of relations between Uzbek and foreign business entities, attracting foreign capital to the country's economy is the quality of the financial information provided, its completeness and transparency. It is difficult for foreign entities to consider financial statements prepared in accordance with Uzbek standards.

In the concept of innovative development of the republic of Uzbekistan in 2019 - 2021, "an important condition for the rapid development of the Republic of Uzbekistan is the rapid introduction of modern innovative technologies in the economy, social and other spheres with the widespread use of scientific and technical chievement. The rapid development of all spheres of society and state life requires the implementation of reforms based on modern innovative ideas", developments and technologies that will ensure the rapid and quality progress of our country on the path to ecoming a leader of world civilization.

Currently the Republic of Uzbekistan is developing the ways of providing foreign investors with the required information environment and access to international financial markets by accelerating transition to international financial reporting standards on the basis of the statutory acts and resolutions of the President of the Republic of Uzbekistan related to accounting, participating in the global financial stock exchanges, as well as improving the system of educating and training specialists in accounting and audit spheres [1].There are a number of urgent problems associated with the preparation of financial statements in compliance with IFRS (International Financial Reporting Standards), in particular, the problems of capitalized borrowings accounting, which require their solution. In this regard, the article discloses the key points and notes that should be taken into account when preparing reports on borrowing costs based on IFRS.

This article looks at some of the practical questions that have been raised about how to apply IAS 23 (International Accounting Standards). It is intended to be guidance on how to apply the standard, not to create a subset of additional rules. Entities should consider the full text of the standards, consult with their auditors and apply professional judgement to their specific accounting questions.

2 ANALYSIS OF THE RELEVANT LITERATURE

The export-oriented economy of Uzbekistan intends to strengthen the penetration on the foreign markets and to have an opportunity of use of soft loans of foreign banks. For this purpose, it is necessary to introduce the international system of the account and the reporting that is the main condition of integration into world economic community. In Uzbekistan, a list of persons who will prepare financial statements on the basis of IFRS starting from the results of 2021 is mandatory. It included joint-stock companies, commercial banks, insurance companies and legal entities classified as large taxpayers [1].

External information plays an important role in the operation of the Single Accounting Center. The basis for the formation of this external management information is the theory of accounting. M.R. Matthews and M.H. Perera noted that "Accounting today is always characterized by the existence of inconsistent, ambiguous or incomplete theories" [3].

It should be noted that the main shortcoming of the theories available today is the lack of a systematic theory that allows the evaluation of practical procedures. In such a situation, the task of effective use of accounting knowledge becomes a priority.

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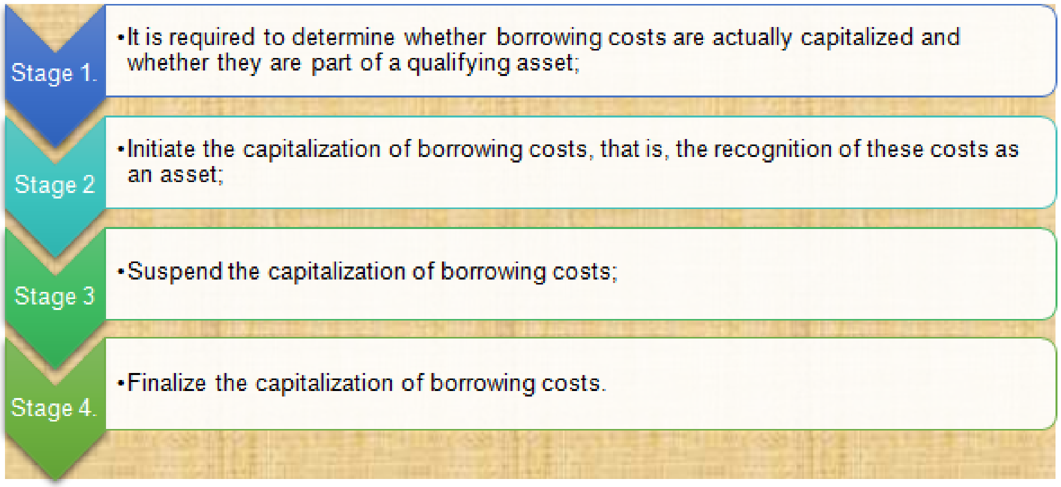

Figure 1: Stages of borrowing costs capitalization

Accounting of costs capitalized in compliance with IFRS is regulated by IAS 23 of International Accounting Standards "Borrowing costs". We consider the basic definitions given in this standard:

Borrowing costs requires that borrowing costs directly attributable to the acquisition, construction or production of a "qualifying asset" (one that necessarily takes a substantial period of time to get ready for its intended use or sale) are included in the cost of the asset.

A qualifying asset is an asset that requires a very long period of time to be ready for use or sale for its intended purpose. [2].

3 RESEARCH METHODOLOGY

Methods of data grouping, analysis and systematic analysis, comparison and expert evaluation were used effectively in the preparation of the scientific article. In addition, monographic observation and analysis of its results were studied and the study used systematic and comparative analysis, economicstatistical method, as well as fundamental rules and concepts presented in the classical and modern works of local and foreign scientists.Borrowing costs include: interest on short-term and long-term loans received from banks and credit institutions,interest expense on financial leasing and interest expense calculated using other efficient interest rate method, exchange rate differences resulting from borrowing in foreign exchange. They should be definitely at the level in which they are consideredappropriate for adjusting the cost of paying interest.

Interest on the loan is capitalized on the basis of the efficientinterest rate. If the interest rate on the loan represents a special interest rate, the capitalization rate will be the same as the special interest rate.

In financial leasing, the amount of capitalization is capitalized for the interest expense on the financial leasing and the assets generated on the basis of this leasing.

When arranging calculation of expenses on borrowing costs, we propose performing capitalization of expenses on loans according to 4 stages:

In the first stage of organizing accounting of borrowing costs it is required to determine the asset to be prepared in reliance upon the definition of the qualifying asset.

The following items can be considered as qualifying assets in economic entities:

- reserves;
- production capacities;
- intangible assets;
- investment real estate facilities;
- harvest-yielding plants.

The following items are not considered qualifying assets in economic entities:

- financial assets;
- assets that are produced in the short term;
- assets that are ready for use or sale for intended purpose at the time of purchase.

According to IAS 23 in stage 2 of organizing accounting of the borrowing costs there are 3 conditions to start capitalization:

- Condition 1.Expenditures are actually incurred(interest expenses or other expenses).
- Condition 2. The borrowing received for a qualifying asset must be utilized for that asset.
- Condition 3.The activities, necessary to generate the asset, must always be in progress.

The borrowing cost raised for a qualifying asset is recognized as an asset only when the above 3 conditions are met simultaneously. If the funds acquired for a qualifying asset are invested over a period of time, the return on investment is deducted from the capitalized amount.

Table 1: Monthly payment schedule for the crane purchased on the basis of financial leasing of "Uzdonmahsulot" JSC, in USD

Maturity date	Current value of the financial liability at the beginning of the period	Monthly payment for financial leasing	Interest expenses by financial leasing (2.5% per month)	The residual value of the financial liability at the end of the period
20.01.2021	342 000	30 000	7 800	319 800
20.02.2021	319 800	30 000	7 245	297 045
20.03.2021	297 045	30 000	6 676	273 721
20.04.2021	273 721	30 000	6 093	249 814
20.05.2021	249 814	30 000	5 495	225 310
20.06.2021	225 310	30 000	4 883	200 192
20.07.2021	200 192	30 000	4 255	174 447
20.08.2021	174 447	30 000	3 611	148 058
20.09.2021	148 058	30 000	2 951	121 010
20.10.2021	121 010	30 000	2 275	93 285
20.11.2021	93 285	30 000	1 582	64 867
20.12.2021	64 867	30 000	872	35 739
		360 000	53 739	

Stage 3 of organizing accounting on borrowing costs may occur in some cases.During the period of preparing a qualifying asset for use, when the activity is ceased for certain reasons, the capitalization of the borrowing cost as an asset must be ceased as well.

At the end of stage 4 of organizing accounting on borrowing costs on preparing a qualifying asset for use, the process of capitalization of borrowing costs must be accomplished as well.

If a company capitalizes borrowing costs, it is reflected in the following two-sided entry:

- Debit: Qualifying asset;
- Credit:Interest accrued.

The capitalization of interest expenses on financial leasing is calculated on the basis of IFRS 16 "Leases" and IAS 23.Below we are analyzing the issue for financial leasing. On January 20, 2021 "Uzdonmahsulot" JSC purchased a crane for the construction of a new elevator on the basis of a financial lease agreement (the annual interest rate stipulated in the lease agreement constitutes 30 percent). Payments under this agreement are shown in the table below.

According to the data presented in the table, the financial lease agreement for 2021 incurred interest expenses in the amount of 53 739 USD. During 2021 the construction crane has been used in the process of construction of the elevator. Hence, this crane is directly related to the creation of a qualifyingasset.Therefore, we can capitalize the costs in the form of interest on financial leasing.Interest expense on financial leasing is reflected in the following double entry:

- Debit: Elevator construction (asset);
- Credit:Interest accrued on financial leasing.

A company may borrow special loans in order to generate a specific qualifying asset.In this case, the capitalization of interest on a special loan is determined by the following formula, as it is clear that the special loan has been used for a qualifying asset:

- C_v=L_a*i
- C_v-capitalized value;
- L_a-amount of attracted loan (borrowing);
- i-interest rate of attracted loan (borrowing).

When a company obtains borrowed funds for general purposes and uses them to acquire a qualifying asset, to determine the amount of costs on the borrowing of the company worthy of capitalization it is recommended to multiply the capitalization rate on the costs incurred on this asset. The capitalization rate is determined as the weighted average cost of the borrowing on the outstanding part of the debt of the company during a certain period. However, a company shall not include in this account the amount of separate borrowings incurred in order to acquire a particular qualifying asset until the preparation of the asset for use or sale for its intended purpose has been completed.The amount of expenses on loans capitalized by the company during the period should not exceed the amount of expenses on loans implemented during this period. [2]

If a company uses total borrowing to obtain a qualifying asset by attracting loans with various interest rates for general purposes, we apply the formula for finding the capitalization rate to determine the amount of expenses on loans that are eligible for capitalization:

$$C_r = \frac{\mathrm{L}_1*\mathrm{i}_1 + \mathrm{L}_2*\mathrm{i}_2 + \mathrm{L}_3*\mathrm{i}_3 + \ldots + \mathrm{L}_\mathrm{n}*\mathrm{i}_\mathrm{n}}{\mathrm{L}_1 + \mathrm{L}_2 + \mathrm{L}_3 + \ldots + \mathrm{L}_\mathrm{n}}$$

- C_r-capitalization rate
- L_1,L_2,L_3,L_n-amount of a loan (borrowing)attracted;
- i_1,i_2,i_3,i_n-interest rate of a loan (borrowing)attracted.
- C_v= Q_s*C_r (F-1)
- C_v-capitalized value;
- Q_s-amount spent to create a qualifying asset

Applying formula F-1 the capitalization rate is calculated on the basis of weighted average cost of the total borrowing (loan) attracted by the company.

Using the formula (F-2) given below, the capitalization rate is calculated on the basis of the weighted average amount of borrowings (loans) in relation to annual interest expenses.

$$C_r = \frac{e_1 * i_1 + e_2 * i_2 + e_3 * i_3 + \ldots + e_n * i_n}{e_1 + e_2 + e_3 + \ldots + e_n}$$

- e_1,e_(2,) e_3,e_n-interest expense on borrowings attracted
- i_1,i_2,i_3,i_n-interest rates on borrowings attracted
- C_v= Q_s*C_r (F-2)
- C_v-Capitalized value;
- Q_s-amount spent to create a qualifying asset.

Now we consider a case-studyfor this proposed formula. In January 2021 "Asakadonmahsulotlari" JSC attracted 3 types of long-term bank loans for general purposes.120 million UZS were at the rate of 22 percent, 250 million UZS were at the rate of 20 and 80 millionUZS were at the rate of 24 percent.A total amount of 300 million UZSof the loan amount attracted in 2021 has been spent on works and services related to the construction of fixed assets. It is required how big amount of interest expense can be capitalized from the amount spent on the construction of fixed assets from borrowed bank loans?

We find the capitalization rates using the formulas F-1 and F-2,that is c_1 and c_2.

Using the formula F-1 $c_1 = \frac{120*22\%+250*20\%+80*24\%}{120+250+80} = 21,24\%$

Using the formula F-2 $e_1 == 120 * 22\% = 26,4 e\_1 = 250 * 20\% = 50 e\_1 = 80 * 24\% = 19,2$

$$c_2 = \frac{26,4*22\% + 50*20\% + 19,2*24\%}{26,4 + 50 + 19,2} = 21,35\%$$

From this example, it is obvious that the capitalization rate differs in terms of these two formulas.Given that the capitalization rate should be determined by the weighted average cost of borrowing, it is recommended to find the average of the capitalization rates c_1 and c_2 obtained from formulas F-1 and F-2.This determines the weighted average of the capitalization rate, which enhances the reliability of the data in our financial statements.

$$c_r = \frac{c_1+c_2}{2} = \frac{21,24\%+21,35\%}{2} = 21,29\% \, Cv = 300 * 21,29\% = 63,87 \text{millionUZS}$$

So, in this case the capitalized value constitutes 63.87 million UZS. We can recognize the value of 63.87 million UZS of interest expenses for 2021 as an asset under the IAS23, which is reflected in the following double entry:

- Debit: Qualifying asset – 63,87 million UZS;
- Credit: Interest accrued– 63,87 million UZS.

4 CONCLUSION

Companies should prepare their financial reporting on the basis of International Financial Reporting Standards, and applying IAS 23 have to reflect the following data:

- The amount of capitalized borrowingcosts during the reporting period;
- The capitalization rate used to determine the amount of capitalized borrowingcosts during the reporting period.

If a company applies International Financial Reporting Standards for the first time in preparing its financial statements, IAS 23 allows for the capitalization of borrowing costs incurred prior to the current reporting period.The recognition of borrowing costs as an asset must definitely be reflected in the company's accounting policies.

In this article we have considered the peculiarities of capitalization of expenses on loans received for general and special purposes, as well as capitalization of interest expenses on leasing operations.We have reviewed the requirements for preparingfinancial statements in compliance with IAS 23.The proposals and recommendations on the stages of capitalization of borrowing costs and calculating capitalization rate have been developed.Preparation of financial statements in compliance with the requirements of IAS 23 using the cost accounting methodology for the proposed borrowing costs will ensure the quality and reliability of financial statements.Consumers of financial information, who use reliable and high-quality information, will be able to make accurate and useful decisions in due time.

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