

Jörgen Holmquist
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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DRAFT ENDORSEMENT ADVICE

Comments should be sent to Commentletter@efrag.org by 25 May 2007

Dear Mr Holmquist

Adoption of IAS 23 *Borrowing costs* (Revised March 2007)

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on the adoption of the IAS23 *Borrowing Costs* (Revised March 2007)—henceforth 'IAS 23 Revised'. The revisions were issued in an exposure draft which EFRAG commented on.

The revisions to IAS 23 result from the Board's consideration of FASB Statement No. 34 *Capitalization of Interest Cost* (SFAS 34). The revision eliminates the option in IAS 23 of recognising borrowing costs immediately as an expense to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. This will align IAS 23 more closely to the requirements of SFAS 34. The other provisions of IAS 23 have not been reconsidered. The revised IFRS will apply for annual periods beginning on or after 1 January 2009, with earlier application being permitted.

EFRAG has carried out an evaluation of IAS 23 Revised. [As part of that process, EFRAG issued a draft version of this letter for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.]

EFRAG supports IAS 23 Revised and has concluded that it meets the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that:

- it is not contrary to the 'true and fair principle' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- it meets the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

For the reasons given above, EFRAG believes that it is in the European interest to adopt IAS 23 Revised and, accordingly, EFRAG recommends its adoption. EFRAG's reasoning is explained in the attached 'Appendix 1 - Basis for Conclusions'.

A minority of EFRAG members has concerns about IAS 23 Revised that cause those members to believe that EFRAG should not recommend IAS 23 Revised for endorsement. The reasoning of those members is explained in the attached 'Appendix 2—Dissenting Views'.

On behalf of the members of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1

Basis for Conclusions

This appendix sets out the basis for the conclusions reached and for the recommendation made by EFRAG on IAS 23 Borrowing costs (Revised March 2007).

- 1 When evaluating the merits of the IAS 23 *Borrowing Costs (Revised March 2007)*—henceforth IAS 23 Revised—EFRAG considered the following key questions:
 - (a) Are the requirements of IAS23 Revised consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework)?
 - (b) Would the revised standard's implementation result in an improvement in accounting?
 - (c) Does the accounting that results from the application of the revised standard meet the criteria for EU endorsement?
- 2 [Having formed tentative views on the issues and prepared a draft endorsement advice letter, EFRAG issued that draft letter for comment on 25 April 2007 and asked for comments on it by 25 May 2007. EFRAG has considered all the comments received in response, and the main comments received are dealt with in the discussion in this appendix.]

Are the requirements of IAS 23 Revised consistent with the IASB's Framework?

- 3 EFRAG has considered whether the requirements of IAS 23 Revised are consistent with the IASB's Framework.
 - (a) For this purpose EFRAG viewed IAS 23 as being primarily about measurement—because it addresses whether borrowing costs form part of the cost of an asset. Although the existing Framework does not say very much about measurement, EFRAG believes that the capitalisation of borrowing costs in the circumstances described in IAS 23 Revised is consistent with what the Framework says on the subject (paragraph 100 of the Framework).
 - (b) Furthermore, what the revised standard says about expensing borrowing costs seems to be consistent with what the Framework says about the recognition of expenses.
 - (c) The Framework also sets out the attributes that make the information provided in financial statements useful to users ('qualitative characteristics'). It goes on to say that "in practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements." EFRAG is of the view that, with IAS 23 Revised, an appropriate balance *has* been achieved. Although some concerns were expressed over the balance between the benefit and cost of the revision, the majority of EFRAG members believe that the benefits exceed the cost. (This is discussed in greater detail in paragraph 11 below.)

Would the revised standard's implementation result in an improvement in accounting?

- 4 EFRAG recommended the existing IAS23 for endorsement because it believed that the standard met the endorsement criteria. EFRAG believes this is relevant to its consideration of IAS23 Revised because, if the existing standard meets the criteria, the revised standard ought to as well unless the elimination of the expensing option has resulted in a deficiency that is not in the existing standard.
- 5 What the revision does is remove an option within an existing standard. As this will result in all entities adopting the same approach to borrowing costs, this will clearly result in greater consistency. On the face of it, greater consistency is a good thing, which is why EFRAG generally favours the elimination of options in standards. EFRAG then went on to consider whether the revision would also enhance comparability in this case.
- 6 In EFRAG's view, this revision improves comparability, and therefore the accounting for qualifying assets, the reason being that within the context of our existing model, which is not based on notions of 'economic cost', borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset *are* part of the historical cost of that asset, and should be capitalised in order for an asset to accurately reflect all costs necessarily incurred to get the asset ready for its intended use or sale.
- 7 It is not enough that comparability is enhanced, because eliminating the wrong option can result in more comparable but less useful information. EFRAG therefore also considered whether the right option had been eliminated. EFRAG members had differing views on this issue.
 - (a) Some EFRAG members believe that, in principle, the revision will result in a more complete implementation of the cost-accruals model. In their view, if one is adopting a cost-based accruals (or probably even a mixed measurement-based) approach, an approach that capitalises expenses directly attributable to the acquisition, construction or production of a capitalised asset is preferable to one that does not.
 - (b) Other EFRAG members believe that there are a number of related issues—including the attribution of borrowing costs to assets, and the inconsistencies that arise between standards—that need to be considered further and addressed appropriately before a conclusion can be reached as to whether capitalisation approach in the revised standard more appropriately meets the objectives of financial reporting than immediate expensing. For that reason, these EFRAG members contend that the IASB has not sufficiently nor convincingly demonstrated why capitalisation is preferable to expensing of borrowing costs.
- 8 EFRAG also considered whether, *if* the elimination of the expensing option will not result in an improvement in accounting, might it instead result in an unacceptable deterioration in accounting. EFRAG noted that entities are already free to apply the capitalisation approach at the moment, so that approach cannot be considered as being unacceptable. For that reason, it concluded that eliminating the expensing option will not result in an unacceptable deterioration in accounting unless, by removing a choice, a cost-benefit issue is created. This is discussed in the next section.

Does the accounting that results from the application of the revised standard meet the criteria for EU endorsement?

- 9 As already mentioned, EFRAG has previously concluded that the existing IAS23 meets the endorsement criteria. In other words, EFRAG concluded that application of the capitalisation approach described in the existing standard (and in the revised standard) would result in financial information that meets the true and fair principle and the characteristics of understandability, relevance, reliability and comparability.
- 10 EFRAG therefore took the view that, in order to decide whether the accounting that results from the application of the revised standard meet the criteria for EU endorsement, it need only focus on the effect of removing the flexibility inherent in having an option in the existing standard.
- 11 In this context, certain EFRAG members expressed their concerns over whether an appropriate balance had been struck between the costs that arise from having a mandatory capitalisation approach and the benefits associated with such an approach. (It should be borne in mind that under the existing IAS 23 the cost of implementation may have been a decisive factor when considering which option to select as an accounting policy.) It was in particular noted that:
- (a) Companies that wish to capitalise their borrowing costs can do so already, so the only benefits that arise from the revised standard are:
 - (i) the enhanced comparability mentioned earlier; and
 - (ii) any contribution the revisions make to the removal of the existing requirement for foreign SEC registrants to reconcile their non-US GAAP financial statements to US GAAP.
- The cost for preparers of implementing the capitalisation approach can be significant. On the other hand, the enhanced comparability should reduce the costs to users of using the information.
- (b) The benefits highlighted in the previous paragraph accrue disproportionately to those relatively few European preparers that are listed (or intending to list) in the US.
 - (c) Some users prefer the expensing approach. That is because they use analytical techniques that require them to reverse capitalised borrowing costs. For example, they might analyse ratios such as interest cover, or they might focus on the level and trend of a company's financing costs. On the other hand, other users prefer the capitalisation approach, for the reasons already explained.
- 12 EFRAG would like to add that it generally favours retrospective application, however in this instance EFRAG accepts the Board's assessment that the cost of retrospective application would outweigh the benefits. Therefore, EFRAG accepts the transitional provisions.
- 13 A number of EFRAG members were also concerned about the ramifications of BC18 of the revised standard, which reads as follows: "The Board recognises that the Standard may require an entity that reconciles its IFRS financial statements to US GAAP to maintain two sets of capitalisation information—one set that complies with the requirements of IAS 23 and one that complies with the

requirements of SFAS 34. The Board wishes to avoid imposing on such entities the need to maintain two sets of capitalisation information. Therefore, before the effective date, the Board will consider what actions it might take to avoid this outcome.”

- (a) Some members were concerned that this might further exacerbate the imbalance between which entities benefit from the revision and which bear the costs mentioned in the previous paragraph.
 - (b) Some members were also concerned about the cost implications to preparers (by way of unnecessary system changes) should the Board decide to postpone/withdraw the effective date at the eleventh hour, on account of the reconciliation requirement not being removed as planned, by 2008.
 - (c) Preparers would be disinclined to spend considerable time and resource to effect the required system changes only to discover later on in the process that such changes are no longer necessary, due to actions taken by the Board to avoid the unfavourable outcome (described in BC 18) for the companies listed in the US.
 - (d) One member was of the view that BC 18 seemed to be suggesting that there could be another revision of the standard. This member was worried about the implications this could have for users looking for consistency of accounting practice and preparers looking to manage changes in practice in a cost efficient way.
- 14 After considering these various arguments, EFRAG concluded that, on balance, IAS 23 Revised satisfies the criteria for EU endorsement, despite the cost/benefit implications it may have for certain companies in Europe.

Appendix 2

Dissenting Views

Two EFRAG members believe that IAS 23 Revised should not be endorsed for use in the European Union and therefore dissent from EFRAG's decision to recommend its endorsement. This appendix sets out the reasons for their dissent.

- 1 The dissenters acknowledge that the Borrowing Costs project forms part of the Memorandum of Understanding (MoU) and that the primary motivation behind the revisions being made to the existing standard is to achieve convergence with US GAAP. Nevertheless, they believe that, contrary to the Memorandum of Understanding, the IASB has not chosen to converge on the better standard and that the costs involved in making this change exceed the benefits that will arise. Consequently, they do not believe that endorsement of the revised standard is in the European interest.
- 2 Their reasoning is as follows:
 - (a) In the view of the dissenters, the capitalisation approach set out in existing IAS 23 has a number of weaknesses that should have been addressed before the approach was made mandatory. Until those weaknesses have been addressed, it is not possible to conclude that the capitalisation approach is preferable to the alternatives available. Similarly, both IAS 23 and SFAS 34 are in need of significant improvement and an in-depth analysis of the benefits and costs of each possible approach to convergence should have been undertaken prior to taking any decision as to how convergence should be achieved.
 - (b) Even if the capitalisation approach is preferable to both the expensing approach and the existing IAS 23, the benefits derived from mandating the application of that approach are not very significant. That is primarily because those companies that would benefit from applying the capitalisation approach are already able to do so and because only some users believe the approach results in better information; other users would reverse the capitalisation out of the balance sheet.

On the other hand, the incremental costs involved for preparers would be significant. Those non-SEC registrants not currently capitalising their borrowing costs (ie the vast majority of companies) would have to put in place the systems and records needed to ensure the amounts capitalised are appropriate. SEC registrants would need to do that as well, but would also—because of differences between US and IFRS capitalisation requirements—have to maintain two sets of capitalisation information unless and until the SEC's reconciliation requirement is eliminated.