ICDS-9 by Anil Gupta

Borrowing Cost

Applicability to heads

- This Income Computation and Disclosure Standard is applicable for computation of income chargeable under the heads:
  1. "Profits and gains of business or profession" or
  2. "Income from other sources",

And **not** for the purpose of maintenance of books of account.

Conflict Resolution (b/w ICDS & Income Tax Act)

- In the case of conflict between the provisions of the Income-tax Act, 1961 ('the Act') and this Income Computation and Disclosure Standard, the **provisions of the Act shall prevail** to that extent.

Deals With [Para 1 of ICDS]

(1) This Income Computation and Disclosure Standard **deals with** treatment of borrowing costs.

Except:

(2) This Income Computation and Disclosure Standard **does not deal with** the actual or imputed cost of owners' equity and preference share capital.

Under Section-208 of Old Companies Act 1956, a company can pay interest on share capital. So in my opinion this is not a borrowing cost.

There is no such Section under new Companies Act 2013.

What are Borrowing Costs? [Para 2(1)(a) of ICDS]

➢ **"Borrowing costs"** are interest and other costs incurred by a person **(Enterprise as per AS-16)** in connection with the borrowing of funds and include:

- Commitment charges on borrowings; **(same in AS 16)**
- Amortised amount of discounts or premiums relating to borrowings; (**same in AS 16)**
- Amortised amount of ancillary costs incurred in connection with the arrangement of borrowings; **(same in AS 16)**
- Finance charges in respect of assets acquired under finance leases or under other similar arrangements. **(same in AS 16)**

In AS 16 there is a 5th cost which has not been included in ICDS 9

As per AS-16 [Para 4] Borrowing costs may include:

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

Explanation: *Exchange differences arising from foreign currency borrowings and considered as borrowing costs are those exchange differences*

which arise on the amount of principal of the foreign currency borrowings to the extent of the difference

between interest on local currency borrowings and interest on foreign currency borrowings.

Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings costs to be accounted for under this Standard and the remaining exchange difference, if any, is accounted for under AS 11, .

For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings

Example. Exchange difference

PRTICULARS	AMOUNT
XYZ Ltd. has taken a loan on April 1, 2013, for a specific project at an interest rate of 5% p.a., payable annually.	USD 10000
On April 1, 2013, the exchange rate between the currencies	Rs. 45 per USD.
The exchange rate, as at March 31, 2014	Rs. 48 per USD
The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate as on April 1, 2013.	11 % p.a.

ASI 10>> Allocation of interest as per AS 16 & AS 11

Particular	Working	Amount
Interest for the period	USD 10,000 x 5%x Rs. 48/USD	Rs. 24,000/-
Increase in the liability towards the principal amount	USD 10,000 x (48-45)	Rs. 30,000/-
Interest that would have resulted if the loan was taken in Indian currency	USD 10000 x 45 x 11%	Rs. 49,500/-
Difference between interest on local currency borrowing and foreign currency borrowing	Rs. 49,500 – Rs. 24,000	Rs. 25,500/-

ASI 10>>Remarks on the allocation of the Interest as per AS-16 & AS-11

- Total amount 54,000. (Interest 24,000 and increase in liability towards principal sum 30,000)
- <u>**Exch. diff,. Is BC or not??**</u> :Out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. (If the Difference (25500) between interest on local currency borrowing (49500) and foreign currency borrowing (24000) is less than the exchange difference on the amount of principal of the FC borrowing (30000) then out of two which ever is less shall be considered)

- Total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 4(a) of AS 16) plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of Rs. 25,500.
- Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

ASI 10>>Change in interest rate on local currency borrowing

If the interest rate on local currency borrowings is assumed to be 13% instead of 11% then:-

- The entire exchange difference of Rs. 30,000 would be considered as borrowing costs,
- In that case the difference between the interest on local currency borrowings and foreign currency borrowings (i.e., Rs. 34,500 (Rs. 58,500 – Rs. 24,000)) is more than the exchange difference of Rs. 30,000.
- Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11.

Qualifying Assets AS 16

As per AS-16 [Para 3.2]

- A qualifying asset is an asset that necessarily takes a **substantial period of time** to get ready for its intended use or sale.

Explanation: What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. (But under ICDS there is no concept of Substantial period)

Note:

- **Meaning thereby that an asset is say purchased on 1st April but put to use on 10th April then whatever the borrowing cost is there for these ten days will be capitalized while it is not so in AS.**

ICDS 9 >> What are Qualifying Assets? [Para 2(1)(b) of ICDS]

"Qualifying asset" means:

- Land, building, machinery, plant or furniture, being tangible assets;
- Know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature, being intangible assets;

Note: Current Assets other than inventory are not included specifically as per the ICDS

Inventories and Borrowing Cost

- Inventories that require a period of twelve months or more to bring them to a saleable condition are Q.A. as per the **ICDS**
- And is same as per **AS-16**
- 1. Inventory is a Q.A., provided it takes a substantial period of time.
- 2. B.C. is not included in the cost of Inventory, unless time is a major factor in bringing about a change in its conditions.

Inventories and Borrowing Cost (Contd…)

- As per Para 8 of ASI 1 (AS-16)
- “Paragraph 5 of AS 16 provides, inter alia, that *"inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets." Paragraph 12 of Accounting Standard (AS) 2, Valuation of Inventories, provides that "Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories".* It is only in exceptional cases, where time is a major factor in bringing about change in the condition of inventories that borrowing costs are included in the valuation of inventories.”

Recognition & Capitalization Norms [Para 3 of ICDS]

Borrowing costs that are directly attributable to the:

- acquisition,
- construction or
- production
- of a **qualifying asset** shall be capitalised as part of the cost of that asset.

The amount of borrowing costs eligible for capitalisation shall be determined in accordance with this Income Computation and Disclosure Standard.

- **Other borrowing costs, if any,** shall be **recognised** in accordance with the provisions of the Act.
- While as per AS 16, **other borrowing costs should be recognised as an expense in the period in which they are incurred.**

Capitalization of B.C. as per the ACT

Section 36(1)(iii) of IT Act

- The proviso to S-36(1)(iii) provides that any amount of the interest paid ,
- in respect of capital borrowed for
- acquisition of an asset ~~(for extension of business or profession)~~
- for any period beginning from the date on which the capital was borrowed for acquisition of the asset till the date on which such asset was first put to use, **shall not be allowed as deduction**.
- **S-43(1)** defines the Actual Cost as:
- **43.(1) "actual cost" means** the actual cost of the assets to the assessee, reduced by **that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority;**
- [**Explanation 8**.—For the removal of doubts, it is hereby declared that where any amount is paid or is payable as interest in connection with the acquisition of an asset, so much of such amount as is relatable to any period after such asset is first put to use shall not be included, and shall be deemed never to have been included, in the actual cost of such asset.]

It can be seen that the Act provides for capitalisation of Borrowing Cost as per S-36(1)(iii) and S-43(1) which is in line with the provisions of ICDS.

Two types of Borrowing costs

- 1. Specific Borrowing cost
- 2. General Borrowing cost

Borrowing Costs eligible for Capitalisation

Specific Borrowing [Para 5 of ICDS]

- To the extent the funds are borrowed specifically for the purposes of acquisition of a qualifying asset, the amount of borrowing costs to be capitalised on that asset shall be the actual borrowing costs incurred during the period on the funds so borrowed. (Same as in AS 16)

- The complexities
- of
- general borrowings

Borrowing Costs eligible for Capitalization AS 16

As per AS-16 [Para 12]

- AS-16 says that, "… the amount of borrowing costs eligible for capitalization should be determined by applying a **capitalization rate** to the expenditure (from general borrowings) on that asset.
- The capitalization rate should be the **weighted average of the borrowing costs**…"

Mechanism of Capitalization under AS-16

- **As per Para 15 of AS-16**, *"The average carrying amount of the asset during a period, including borrowing costs previously capitalized, is normally a reasonable approximation of the expenditure to which the capitalization rate is applied in that period."*
- **As per Para 12 of AS-16**, *"…….The amount of borrowing costs capitalized during a period should not exceed the amount of borrowing costs incurred during that period……"*

Recap General BC… AS 16

- **1.** Capitalization rate to the expenditure (from general borrowings) on that asset.
- *Capitalization amount =*

  *Funds applied * capitalization rate*

- 2. The capitalization rate should be the weighted average of the borrowing costs…”
- *3. The average carrying amount of the asset during a period, including borrowing costs previously capitalized,*
- *4. 5. Borrowing costs capitalized during a period should not exceed the amount of borrowing costs*

Example to illustrate weighted average method

A Ltd has the following borrowing in the year for capital purposes: Assume all the borrowings were obtained at the beginning of the year and the assets were purchased at the end of the year.

General borrowings were Rs. 80 Lakhs @ 10% from Corporation Bank and Rs. 120 Lakhs @ 12% from Canara Bank.

Asset	Cost of Asset	Borrowings	
		General	Specific
Asset 1	Rs.100 Lakhs	Rs. 100 Lakhs	----
Asset 2	Rs. 125 Lakhs	Rs. 25 Lakhs	Bank loan Rs.100 Lakhs @ 10%
Asset 3	Rs. 150 Lakhs	Rs. 75 Lakhs	9% debentures of Rs. 75 Lakhs
Other Assets	Rs. 150 Lakhs (From owned funds)	----	----
Total Assets	Rs. 525 Lakhs	Rs. 200 Lakhs	Rs. 175 Lakhs

Example to illustrate weighted average method [Contd…]

Solution

General Borrowing cost = Rs. 22.40 Lakhs

(80*10% + 120*12%)

Weighted average capitalization rate = (80*10 + 120*12)/ 80+120= **11.20%**

BC as per AS

Asset	Borrowing	Cost (Rs. Lac)	Interest (%)	Int (Rs. Lac)	Total Asst Cost (Rs. Lac)
Asset 1	General	100.00	11.20%	11.20	111.20
Asset 2	Specific	100.00	10%	10.00	137.80
	General	25.00	11.20%	2.80	
Asset 3	Specific	75.00	9.00%	6.75	165.15
	General	75.00	11.20%	8.40	

Example to illustrate the provisions of inclusion of BC in total cost (AS-16):

Expenditure on the Q.A. is incurred at the last date of the month
Rate of interest: 1% per month
Loan amount: 20 Lakhs
10 Lakhs have been repaid on 1st September.

Month	Expenditure on Q.A. (Rs.)	Interest Capitalized (Rs.)	Cumulative Expenditure including interest
April	2,00,000	-	2,00,000
May	3,00,000	2,000	5,02,000
June	1,00,000	5,020[1]	6,07,020
July	7,00,000	6,070	13,13,090
August	1,50,000	13,131	14,76,221
September	50,000	**10,000[2]**	15,36,221
	15,00,000	**36,221**	

Example to illustrate the provisions of Para 12 & Para 15 (AS-16) contd…

1. Interest rate is applied to the average carrying amount of the asset, **including the interest previously capitalized (Para 15 of AS-16).**

2. The amount for capitalization @ 10 % of 14,76,221 is Rs. 14,762. But, since the amount of 10 Lakhs has been repaid on 1st September, the actual borrowing cost for the month is just Rs. 10,000 (10,00,000*1%). Therefore, **the lesser of the 2 amounts will be capitalized as per Para 12 of AS-16.**

Borrowing Costs eligible for Capitalization as per ICDS

General Borrowing [Para 6 of ICDS]

- To the extent the funds are borrowed generally and utilised for the purposes of acquisition of a qualifying asset, the amount of borrowing costs to be capitalised shall be computed in accordance with the following formula namely :—

A X B/C

Where **A =** borrowing costs incurred during the **previous year** except on borrowings directly relatable to specific purposes;

B = **(i)** the average of costs of qualifying asset as appearing in the balance sheet of a person on the first day and the last day of the previous year; or

(ii) in case the qualifying asset does not appear in the balance sheet of a person on the first day or both on the first day and the last day of previous year, half of the cost of qualifying asset;

General Borrowing Formula [Contd…]

(iii) in case the qualifying asset does not appear in the balance sheet of a person on the last day of previous year, the average of the costs of qualifying asset as appearing in the balance sheet of a person on the first day of the previous year and on the date of completion, other than those qualifying assets which are directly funded out of specific borrowings; **or**

Note: We are unable to understand why the "OR" is mentioned above.

Note: In case of "B" i.e. the computed cost of Q.A. in Para 6 three situations have been given B(i) and/or B(ii) and/or B(iii). Though in Para 6 there is no clarification w.r.t. "and/or" but we have assumed it to be so.

C = the average of the amount of total assets as appearing in the balance sheet of a person on the first day and the last day of the previous year, other than those assets which are directly funded out of specific borrowings;

Note on Formula as per ICDS 9:

Note: The following Example has been given for better understanding of the Formula.

(A)	**Total of General Purpose Borrowing Cost**	
(B)	Cost of Qualifying Assets:	
(i)	If it is appearing in B/S on first and last day or	Avg. of Cost as on first and last day
(ii)	If it is not appearing in B/S on first day or both on first as well last day or	Half of Cost of Qualifying Asset
(iii)	If it is not appearing in B/S on last day	Avg. Cost as on first day and date of completion
(C)	In denominator take Avg. of total assets on the first day and last day of the year (not including those assets which are directly through specific borrowing)	

Example [Comparison of AS and ICDS]

(A) General Borrowing cost	Total B.C. (1,800) – Specific B.C. (800) = Rs. 1000					
(B) Average Cost of Qualifying Assets						
Balance Sheet Items	Cost of QA as on 01.04. 2015	Cost of QA as on 31.03. 2016	Capitalization Base for ICDS	Basis as per ICDS	Date of Purchase	Date of Ready to use
Qualifying Fixed Assets as per ICDS						
B(i)	If Q.A. is appearing in B/S on both first and last day					
Assets under construction completed during the year (Period of Construction > 12 months)	2,000	5,000	3,500	Average of Opening & Closing	-	31/10/ 2015
B(ii)	If Q.A. is not appearing in B/S on first day or both first as well as last day					
Assets acquired during the year but not put to use	-	10,000	5,000	@ 50 % of cost	01/06/ 2015	-

Example [Comparison of AS and ICDS] contd…

B(iii)	If Q.A. is not appearing in B/S on last day					
Assets put to use during the year and has been sold. Assuming no additional cost incurred during the year.	6,000	-	6,000	Avg. of Cost as on first day and date of completion	-	-
Subtotal of all Qualifying Assets (B)	8,000	15,000	14,500 (B)			
Other Assets as per B/S (Including Current Assets)	12,000	12,000	12,000			
(C) Average of Total Assets on first and last day	20,000	27,000	26,500 (C)	Average of Opening & Closing		

Computation of BC to be capitalized

As per ICDS:

A*B/C = 1,000 (A) * 14,500 (B) / 26,500 (C) = Rs. 547

As per AS:

Interest Capitalization assuming rate of interest is 10%		
1.Assets under construction completed during the year (Period of Construction > 12 months)	Cost as at year end = 5,000	Date when ready to use = 31/10/2015
Base amount for Capitalization	5,000	
Interest to be capitalized	5,000 * 7/12 * 10% = 292	
2.Assets acquired during the year but not put to use	The asset is not a Q.A. as it is ready for use when purchased, just not put to use.	
3.Assets put to use and sold during the year	The asset is not a Q.A. as it is ready for use when purchased, just not put to use.	

Total Interest Capitalized under AS = 292

Note: It is not clear that how the provisions for commencement and cessation have been incorporated in the formula as per the ICDS as the borrowing cost taken as "A" is for the **whole previous year and not for the capitalization period.**

Commencement of Capitalization [ICDS]

- The capitalisation of borrowing costs shall commence:
  (a) in a case referred to in paragraph 5 **(Specific Borrowing),** from the date on which funds were **borrowed**;
  (b) in a case referred to in paragraph 6 **(General Borrowing),** from the date on which funds were utilised.

As per AS-16 [Para 14]

- The capitalisation of borrowing costs as part of the cost of a qualifying asset should commence **when all the following conditions are satisfied:**

……(c) activities that are necessary to prepare the asset for its intended use or sale are in progress….. *(…funds were utilised..)*

Suspension of Capitalisation

As per AS-16 [Para 17]

- Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.
- **ICDS does not state any such provision, which means that the capitalisation of borrowing costs will continue even when the activities are suspended.**

<u>Cessation of Capitalization</u> [Para 8 of ICDS]

- Capitalisation of borrowing costs shall cease:

(a) in case of a qualifying asset (tangible or intangible), when such asset is **<u>first put to use</u>**;

Though as per AS-16, capitalization shall cease when the asset is **<u>ready for use</u>**.

(b) in case of inventory, when substantially all the activities necessary to prepare such inventory for its intended sale are complete.**(Same in AS-16)**

Completion of a part of Asset [Para 9 of ICDS]

- When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part shall cease:

(a) in case of part of a qualifying asset (tangible and intangible), when such part of a qualifying asset is first put to use; Though as per AS-16, it shall cease when the part is ready for use.

(b) in case of part of inventory, when substantially all the activities necessary to prepare such part of inventory for its intended sale are complete.(Same in AS-16)

Interest income???

Under AS 16 the interest earned on invsetment of temporary deployment of funds during the acquisition of asset is to be reduced from the cost of asset or from BC

While under ICDS it is income from other source.

SC ruling in Tuticorin Alkali Chemicals (227 ITR 172) requires that interest income earned from temporary deployments of funds has to be offered to tax immediately as IFOS. Hence above deviation has no tax impact.

The income which was earlier deducted from borrowing cost as per AS will be included in Income itself as per ICDS, and hence, will lead to an **increase in profits.**

Transitional Provisions [Para 10 of ICDS]

- All the borrowing costs incurred on or after 1st day of April, 2015 shall be **capitalised** for the **previous year commencing on or after 1st day of April, 2015 i**n accordance with the provisions of this standard
- **after taking into account** the amount of borrowing costs **capitalised,** if any, for the same borrowing for any previous year ending on or before 31st day of March, 2015.
- What is the meaning of "after taking into account" ???

- **Example for better understanding:** Suppose a loan is borrowed in January' 2015 and asset is purchased at the same time, but put to use in May '2015. As per AS-16, the interest will be treated as revenue expense at the year end because the asset is not a qualifying asset as it is ready for use when purchased.
- Now as per ICDS whether transitional provisions will be applicable ?

Yes, it will be. Why??

- This is because in March'2015, the Borrowing cost has not been capitalized. But now, as per ICDS, this is a Q.A. as it has not been put to use when bought. So, the interest which was earlier treated as revenue expense will now be reversed and capitalized as per ICDS.

Disclosure Requirements [Para 11 of ICDS]

The following disclosure shall be made in respect of borrowing costs:

(a) the accounting policy adopted for borrowing costs;

(b) the amount of borrowing costs capitalised during the previous year.

As per AS-16 [Para 23] : Same as ICDS

Situations as per ICDS which will lead to a change in Profits.

			Sources	
S.NO	Situations	Impact on Income (Increase/Decrease)	ICDS	AS
1	Exchange diff. on foreign currency borrowing to the extent its regarded as adjustment to interest , excluded from B.C.	**increase ,** because now the whole amount will be treated as capital expense	Para 2(a)	Para 4
2	Scope of Qualifying Assets enlarged	**Increase**, as borrowing cost related to more assets will be capitalized	Para 2(b)	Para 3
3	Revenue on Temporary Investment not deducted from capitalization amount.	**Increase,** as treated as income separately	----	Para 10

Situations as per ICDS which will lead to a change in Profits contd….

4.	Commencement of Capitalization – conditions minimalized	**Increase**	**Para 7**	**Para 14**
5.	Capitalization even during suspension of activities	**Increase**	----	Para 17
6.	Cessation of Capitalization – ready to use converted to put to use	**Increase**	Para 8	Para 19
7.	Completion of a Part – Scope of Capitalization increased	**Increase**	Para 9	Para 21

THANK YOU