23 August 2006

Professor David Boymal
Australian Accounting Standards Board
PO Box 204
Collins Street West Vic 8007

Dear David,

## ED 149 *Proposed Amendments to AASB 123 Borrowing Costs*

We are pleased to submit our comments in relation to Exposure Draft ED 149 *Proposed Amendments to AASB 123 Borrowing Costs*.

Overall, we do not support the AASB's decision to only require capitalisation of borrowing costs.

**Question 1**
*The ED 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?*

*Draft Comments from EY Global*
We do not support the removal of the option to expense borrowing costs as they are incurred. We also do not support the proposed requirement that all borrowing costs are to be capitalised due to the following reasons:

- The ED does not include any real conceptual arguments as to why capitalisation of borrowing costs is superior to expensing borrowing costs.

  BC 10 states that "… the capitalisation of borrowing costs enhances comparability between assets internally developed and those acquired from a third party." This reasoning is, however, flawed as assets acquired will also contain a profit element paid to the third party that will not be included in assets internally developed, therefore comparability is not actually achieved.

  BC 7 – 9 contain arguments as to how capitalisation of borrowing costs meets the definition of historical cost. However, there are other methods of financing construction activity, for example equity contributions, the costs of which are not permitted to be capitalised. Therefore comparability between entities who have internally developed assets is also not achieved.

The ED contains no reasoning as to why expensing borrowing costs no longer fits within the framework – which previously had been the benchmark treatment.

- BC 3 acknowledges that neither the existing IAS 23 **nor** SFAS 34 are considered to be "…of a clearly higher quality than the other." Nevertheless IAS 23 is being amended to converge with SFAS 34, which we believe is contradictory and will not enhance the quality of financial reporting.

  BC 2 states that one of the reasons for the change is to achieve "…convergence in principle with US GAAP" while BC 3 states "…convergence on the detailed aspects of accounting treatments is not necessary." We do not agree that removing the option to expense will achieve "convergence in principle", nor will it always remove the need for reconciliation. For example, fundamental differences exist between IFRS and US GAAP, as noted below, such that significant differences in the carrying value of assets may arise with the application of the capitalisation policy:

  - The definition of a qualifying asset is wider in SFAS 34, specifically in respect of associate investments.
  - The date at which to commence/cease/suspend capitalisation differs.
  - The definition of borrowing costs is wider in IAS 23. IAS 23 includes foreign exchange differences to the extent it is an adjustment to the interest cost, which is not included within SFAS 34. For developing countries with significant investments this can be a material amount. In addition, IAS 32 often requires more instruments to be classified as liabilities, therefore giving rise to more borrowing costs.
  - US GAAP contains specific guidance outside of SFAS 34 as to how derivatives are to be taken into account when determining how much borrowing costs are to be capitalised. IFRS contains no such guidance and varying interpretations exist.

- As noted in the ED, IAS 23 was written many years ago. It provides little guidance to assist with the application of the capitalisation method which itself leads to inconsistent application of the requirements. An amendment proposing to increase the use of this method without providing greater clarity and guidance will only perpetuate the inconsistent application of IFRS which will undermine the effectiveness of IFRS as a high quality framework of accounting.

  While not specified in the ED, this would appear to be the first step in amending the standard, as within time the Board **will** need to revisit the standard due to the points discussed above. Amending standards in such a "piecemeal" manner does not promote consistency and stability.

- SFAS 34 was also written many years ago, and it is acknowledged that it is not necessarily a high quality standard. The ED has no discussion as to whether or not FASB intends to remedy this and propose changes to the standard, and if so when such changes are likely. Without this knowledge, making a change to achieve a level of convergence with US GAAP may contribute to the uncertainty and instability of accounting. We urge the Board to be careful of "quick fixes" and convergence for the sake of convergence.

- We conducted a survey of financial statements prepared in accordance with IFRS for 2005 and found that a majority (67%) had adopted the benchmark treatment to expense borrowing costs rather than capitalise. Our survey also indicated that those entities who did capitalise borrowing costs were primarily driven by their previous GAAP requirements to require capitalisation – therefore reducing the need to calculate an adjustment – or had significant investments in infrastructure/real estate in developing countries, or were required to prepare a reconciliation with US GAAP - and therefore this option reduced the extent of differences. In this sample 25% of the SEC foreign private issuers had a reconciling item relating to capitalised borrowing costs.

In summary, we do not agree with the requirement that all borrowing costs should be capitalised and would propose that if an option is to be eliminated, it should be option to capitalise borrowing costs, with appropriate influence on the FASB in order to achieve future convergence.

Should the Board still conclude that capitalisation of borrowing costs is to be required, we propose that further changes and further guidance on the application of the broad principles are to be included in the standard in order that there is at least consistency of implementation of the capitalisation model under IFRS if not true convergence. More specifically, this should include:

a) guidance on the interaction between IAS 23 and IAS 39 with respect to derivatives on borrowings, and early settlement of borrowings and related derivatives;
b) guidance on the application of adjustments to interest for foreign exchange differences;
c) guidance on the application of identifying general borrowings; and
d) Clarification of the interaction between IAS 23 and IAS 40. BC 4 explains that an assets carrying value, if carried at fair value at the time construction activities are taking place, is not affected by whether or not borrowing costs are capitalised. This is correct; however the view of the performance of the entity is affected, as the amount attributed to the change in fair value of the asset will be overstated, as will the finance costs for the period, if the effects of the borrowing costs are not taken into account. Paragraph 17 of IAS 40 and the related paragraphs B40-42 of IAS 40 refer this argument for the treatment of subsequent costs of investment property; therefore the proposed scope amendments introduce a conflict with other standards.

*Comments from EY Australia*

In addition to the draft comments raised by EY Global above, from an Australian public sector perspective, we believe that the removal of the option in AASB 123 of recognising borrowing costs immediately as an expense would create a convergence difference between Generally Accepted Accounting Principles (“GAAP”) and Government Financial Statistics (“GFS”) at a time when the Saab’s GAAP / GFS project is attempting to remove differences and not create additional ones. We note that the proposals in AASB 123 conflict with ED 142 *Financial Reporting of General Government Sectors by Governments* (July 2005) which proposed for all borrowing costs of the General Government Sector to be expensed in determining the operating results and believe that the AASB should specifically consider this issue.

**Question 2**
*This ED proposes that entities should apply the amendments to borrowing costs of which the commencement date for capitalisation is on or after the effective date. However, an entity would be permitted to designate any date before the effective date and to apply the proposed 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?*

The proposed transition approach, if the capitalisation method is to be adopted, is considered to be the most practical solution. We note however that this will not achieve comparability with those entities that have been applying the capitalisation policy for some time, or those entities that were first time adopters prior to the proposed consequential amendment to IFRS 1 who were required to apply this retrospectively.

We would be pleased to discuss our comments further with you. Please contact Mark Seddon on (03) 8650 7444 if you wish to discuss any of the matters raised in this response.

Yours faithfully,

Ernst & Young