AS-16: Borrowing Costs

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Introduction

The interest component or borrowing costs is one of the most important item in an organization's financial statements and its treatment can have an impact on the overall presentation of financial statements. It was, therefore, necessary to introduce some guidelines in the form of an Accounting Standard (i.e. AS-16) for providing the treatment that is to be made in the case of Borrowing Costs. To further understand and illustrate the depth of AS-16, I have prepared this article. The article is divided into the following parts:

1. What is Accounting Standard 16?
2. Recognition and Presentation of Borrowing Costs
3. Borrowing Costs from the viewpoint of Income Tax Act, 1961
4. Borrowing Costs from the viewpoint of GST Act, 2017.

Borrowing Costs

Accounting Standard -16

Borrowing Cost is the interest and other cost which is incurred by an enterprise in relation to borrowing of funds. The main objective of this accounting standard is only to prescribe accounting principles for accounting of borrowing costs. This AS clearly specifies that it is **not related** with **cost of equity shares or preference shares but only related to borrowing of funds.**

The following points should be considered for the purpose of borrowing costs:

a) Interest on short term loans or long-term debts should be included as a part of borrowing cost.

b) If any enterprise has incurred ancillary cost (related) for the arrangement of funds, then amortized part of such cost should also be included as a part of borrowing cost.

c) Discounts / Premiums which are incurred by an enterprise in relation to arrangement of fund, such amount should not be taken in total but amortised part of Discount & Premium should be included as a part of borrowing cost.

On the basis of above explanation, premium is also considerable for the purpose of borrowing cost. Such premium can be taken as a part of expense only if it is related to Redemption of funds because premium related to receipt of securities should be considered as Reserve & Surplus and not as an expense.

d) Amount of Interest should also be included as a part of borrowing cost which is paid or payable for finance lease agreement. (AS 19).

e) Exchange Difference related to Foreign Currency Loans. (AS 11)

Recognition of Borrowing costs:

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized as part of the cost of that asset. Other borrowing costs should be recognized as an expense in the period in which they are incurred.

Borrowing costs are capitalized as part of the cost of a ***qualifying asset*** when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognized as an expense in the period in which they are incurred.

What are qualifying assets?

Qualifying assets are those that take substantial period of time to keep ready for use or sale. As per Accounting Standard Interpretation No. 1, substantial period of time is the period of 12 months. But longer period or short-term period than specified period may also be considerable as per the interpretation issued by Institute of Chartered Accountants of India. On the basis of interpretation, it can be said that a fixed period is not explained by interpretation but reasonable judgment based on circumstances should be applied. Moreover, it also depends on the industrial criteria, that how much time will it take to construct or produce the qualifying asset.

For example, where an industry defines time period of 3 years to produce the product and make it ready for use, then the enterprise will consider this time period as their substantial time period only.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those 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. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

<u>As per AS 16, amount of borrowing cost to be recognized is as follows:</u>

a) If any borrowing cost is incurred for qualifying assets, then the amount of borrowing cost should be capitalized in the cost of Qualifying asset.

b) If any borrowing cost is not having any connection with Qualifying asset, then such amount should be transfer to P/L A/c as an expense.

<u>Conditions of AS 16:</u>

As per AS 16, there are three situations or conditions which are specified in relation to capitalization of borrowing cost.

<u>A) Commencement of Capitalization:</u>

As per the provision of accounting standard, any enterprise can capitalize its borrowing cost only if the following three conditions are satisfied.

<u>(i) Expenditure should be incurred:</u> If any enterprise wants to capitalize borrowing cost, then it is very necessary that all the borrowed funds have been incurred for qualifying asset. If any amount is still pending for expenditure purpose out of borrowing funds, then the pending amount will not be considered for capitalization purposes.

<u>(ii) Interest cost should be actual:</u> Borrowing cost cannot be capitalized on assumption basis but it should be payable on actual basis outside the enterprise.

(iii) Activities should be continued which are required to complete the production, construction, acquisition of qualifying asset. Activities may be in the nature of physical or administrative but activities should be related to completion of Qualifying asset.

<u>B) Suspension of Capitalization:</u>

If any enterprise has discontinued the necessary activities, then capitalization of borrowing cost cannot be made from the date of discontinuation of required activities. ***Such period of discontinuation should be recognized as Suspension period.***

Exception: If any stoppage of necessary activities is of temporary in nature then such stoppage cannot be covered under suspension of capitalization of borrowing cost. Temporary reason means the enterprises are having proper judgment about continuation of discontinued activities.

Note: Borrowing cost which are related to the suspension period should be transferred to P/L A/c as an expense.

<u>Due to the outbreak of Covid-19, The Institute of Chartered Accountants of India has issued an accounting advisory in March 2020, wherein they mentioned that:</u>

AS 16 require that the capitulation of interest is suspended when development of an asset is suspended. ***The management may consider this aspect while evaluating the impact of COVID-19.***

<u>C) Cessation of Capitalization:</u>

As per this Accounting Standard, ***borrowing cost can be capitalized in the cost of qualified asset till the date of completion of construction, acquisition or production.*** It can be also said that if any asset is ready for use or sale, no capitalization can be made after the date of specified purpose of use or sale. If any qualified asset is completed in parts, then it will be recognized that the completed part is dependent or independent from the point of view of their use or sale.

<u>Important points to be considered:</u>

1. If any enterprise has to recognize any Government grant in relation to construction, production or acquisition of qualifying asset, then expenditure on such qualifying asset will be calculated after deducting such grant out of total expenditure.

2. If any enterprise has received any progress payment in relation to completion of qualifying asset, then such progress payment should be adjusted for the calculation of expense incurred.

<u>Types of borrowings:</u>

a) <u>Specific Borrowing:</u> If any enterprise can recognize direct relationship between Qualifying assets and amount of loan then the situation will be covered under the heading of specific borrowing. In such case, the entire borrowing cost can be capitalized to the related assets.

b<u>) General Borrowings:</u> In case of General Borrowings there will be no direct relationship between qualifying assets and borrowed funds. In case of general borrowings, there may be more than one Qualifying asset or more than one type of loan. In such case capitalization of borrowing, cost should be made in the ratio of expense incurred on Qualifying asset.

<u>Disclosures in Financial Statements:</u>

1. Accounting policy should be disclosed separately.

2. Amount of borrowing cost which is capitalized during the period should be disclosed separately.

<u>Explanation of Interest Expense on borrowed funds from the viewpoint of Income Tax Act, 1961:</u>

Interest expense as per the Income Tax Act,1961 **(S. 2(28A))** is defined as under:

"Interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilised;

<u>1. Tax Deduction on Home Loan Interest u/s 24:</u> Homeowners can claim a deduction of up to ***Rs.2 lakhs*** on their home loan interest, ***if the owner or his family resides in the house property. The same treatment applies when the house is vacant. <u>If you have rented out the property, the entire home loan interest is allowed as a deduction.</u>***

However, deduction on interest is **limited to Rs.30,000** instead of Rs.2 lakhs if both the following conditions stand satisfied:

a. The loan is taken on or after 1 April 1999 or

b. The purchase or construction is not completed within 5 years from the end of the Financial Year in which loan was availed.

<u>2. Interest paid or payable for money/ capital/ loan borrowed for the purpose of business u/s 36(1)(iii):</u>

a. Money borrowed must be used for the *purpose of business*- whether for purchase of capital asset or for revenue purposes.

b. The interest allowed is subject to:

- Where the loan is taken from a Bank or Financial Institution-Subject to restriction ***u/s 43B i.e. will be allowed only if <u>PAID</u> before the due date.***

  Or

- Where loan is taken from a person other than a Bank/FI- it is restricted by ***S. 40a (where TDS deductible u/s 194A or 195 and TDS was deducted before 31st March and deposited on or before 30th September or 31st July.)***

c. Where the money is borrowed for the purchase of a capital asset, then interest payable or paid will be capitalized (added to the actual cost of asset), for the period ***before*** the asset is put to use. However, ***after*** the date when the asset is put to use, it shall be allowed as a deduction.

<u>3. Loan Taken from a director or a related party u/s 40A(2)(b):</u> This section provides power to the assessing officer, that in case any expenditure has been incurred and payment has been made or is to be made to certain specified persons and he is of the opinion that such expenditure is excessive or unreasonable with respect to the fair market value of goods and services offered, he may disallow such expense as he considers to be excessive or unreasonable.

So if a loan is being given to the enterprise by a director at a high rate of interest, then the excess amount of interest may be considered excessive by the assessing officer and hence may be disallowed.

<u>4. TDS on Interest other than Interest on securities (S.194A):</u>

- Section 194A deals with deduction of TDS on interest other than interest on securities like Interest on Fixed Deposits, Interest on Loans and Advances other than banks.

- This Section is only applicable to a resident. Thus, the provisions of section 194A are not applicable in case of payment of interest to a non-resident.
- Payments made to **non-residents** are also covered under TDS mechanism. However, tax in such a case is to be deducted as per Section **195 (i.e. 20%).**

  Following are the applicable rates of taxes:

  - 10% when the PAN is furnished;
  - 20% if the PAN is not provided.
  - No surcharge, health and education cess shall be added to the above rates. Hence, tax will be deducted at source at the basic rate.

Explanation of Interest Expense on borrowed funds from the viewpoint of Goods and Services Tax,2017:

Under GST, **Supply** is considered as a **taxable event** for charging tax. The liability to pay tax at the 'time of supply of goods or services'.

Supply includes sale, transfer, exchange, barter, license, rental, lease and disposal. If a person undertakes either of these transactions during the course or furtherance of business for consideration, will be considered under the meaning of supply under GST.

The Goods and Services Act defines interest under ***clause (zk) of the Notification No. 9/2017-Integerated Tax Rate issued on 28.06.2017***. The relevant extract is given as under:

In exercise of the powers conferred by sub-section (1) of section 6 of the Integrated Goods and Services Tax Act, 2017 (13 of 2017), the Central Government, on being satisfied that it is necessary in the public interest so to do, on the recommendations of the Council, hereby exempts the ***inter-State supply of services*** *of description as specified in column (3) of the Table below from so much of the Integrated Tax leviable thereon under sub-section (1) of section 5 of the said Act, as is in excess of the said tax calculated at the rate as specified in the corresponding entry in column (4) of the said Table, unless specified otherwise, subject to the relevant conditions as specified in the corresponding entry in column (5) of the said Table, namely:-*

(zk) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) but does not include any service fee or other charge in respect of the moneys borrowed or debt incurred or in respect of any credit facility which has not been utilized;

Also, Entry 27(a) of the Notification No. 12/2017 and Entry 28(a) of the Notification No. 9/2017 exempts the ***intra state supply*** of services.

The service (lending of funds) is covered under the above Notification. Therefore, such services are exempted from payment of GST and the ***lending company is not required to discharge GST on the activity of providing services by way of extending deposits, loans or advances where the consideration is represented by way of interest.***

This Notification clearly shows that the interest payable on borrowed funds is exempt under the Goods and Services Act, 2017. But the amount spent on raising the loan, processing fees or Bank Charges are liable to GST.

Conclusion:

Now, it is very much clear that the borrowing costs have different treatment under various laws and regulations. It is, therefore, very important that the borrowing costs are treated keeping in mind the various provisions of these laws and regulations and there is no violation of them.