

# AS 16 – BORROWING COSTS

## Illustration 1

PRM Ltd. obtained a loan from a bank for ₹ 120 lakhs on 30-04-20X1. It was utilised as follows:

Particulars	Amount (₹ in lakhs)
Construction of a shed	50
Purchase of a machinery	40
Working Capital	20
Advance for purchase of truck	10

Construction of shed was completed in March 20X2. The machinery was installed on the date of acquisition. Delivery of truck was not received. Total interest charged by the bank for the year ending 31-03-20X2 was ₹ 18 lakhs. Show the treatment of interest.

### Solution

Qualifying Asset as per AS 16 = ₹ 50 lakhs (construction of a shed)

Borrowing cost to be capitalised =  $18 \times 50/120 = ₹ 7.5$  lakhs

Interest to be debited to Profit or Loss account = ₹ (18 – 7.5) lakhs = ₹ 10.5 lakhs

## Illustration 2 (RTP May'24)

X Ltd. began construction of a new building on 1st January, 20X1. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 20X1 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	Rate of Interest
₹ 5,00,000	11%
₹ 9,00,000	13%

The expenditures that were made on the building project were as follows:

		₹
January	20X1	2,00,000
April	20X1	2,50,000
July	20X1	4,50,000
December	20X1	1,20,000

Building was completed by 31st December 20X1. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalised and pass one Journal Entry for capitalising the cost and borrowing cost in respect of the building.

### Solution

#### (i) Computation of weighted average accumulated expenses

		₹
₹ 2,00,000 x 12 / 12	=	2,00,000
₹ 2,50,000 x 9 / 12	=	1,87,500
₹ 4,50,000 x 6 / 12	=	2,25,000
₹ 1,20,000 x 1 / 12	=	<u>10,000</u>
		6,22,500

#### (ii) Calculation of weighted average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest	Amount of interest (₹)
5,00,000	11%	= 55,000
9,00,000	13%	= 1,17,000
14,00,000		= 1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000} \times 100\right)$		= 12.285% (approx.)

**(iii) Interest on weighted average accumulated expenses**

	₹
Specific borrowings (₹ 1,00,000 x 10%)	= 10,000
Non-specific borrowings (₹ 5,22,500 * x 12.285%)	= 64,189
Amount of interest to be capitalised	= 74,189

**(iv) Total expenses to be capitalized for building**

	₹
Cost of building ₹ (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189

10,94,189

**(v) Journal Entry**

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12.20X1	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalised)			

**Illustration 3 (MTP Oct '21)**

The company has obtained Institutional Term Loan of ₹ 580 lakhs for modernisation and renovation of its Plant & Machinery. Plant & Machinery acquired under the modernisation scheme and installation completed on 31<sup>st</sup> March, 20X2 amounted to ₹ 406 lakhs, ₹ 58 lakhs has been advanced to suppliers for additional assets and the balance loan of ₹ 116 lakhs has been utilised for working capital purpose. The Accountant is on a dilemma as to how to account for the total interest of ₹ 52.20 lakhs incurred during 20X1-20X2 on the entire Institutional Term Loan of ₹ 580 lakhs. **(5 Marks)**

**Solution**

As per para 6 of AS 16 'Borrowing Costs', borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

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

The treatment for total interest amount of ₹ 52.20 lakhs can be given as:

Purpose	Nature	Interest to be capitalized	Interest to be charged to P&L account
		₹ in lakhs	₹ in lakhs

Modernisation and renovation of plant and machinery	Qualifying asset	$**52.20 \times \frac{406}{580} = 36.54$	
Advance to supplies for additional assets	Qualifying asset	$**52.20 \times \frac{58}{580} = 5.22$	$52.20 \times \frac{116}{580} = 10.44$
Working Capital	Not a qualifying asset	41.76	10.44

\* 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 the facts and circumstances of the case.

\*\* It is assumed in the above solution that the modernisation and renovation of plant and machinery will take substantial period of time (i.e. more than twelve months). Regarding purchase of additional assets, the nature of additional assets has also been considered as qualifying assets. Alternatively, the plant and machinery and additional assets may be assumed to be non-qualifying assets on the basis that the renovation and installation of additional assets will not take substantial period of time. In that case, the entire amount of interest, ₹ 52.20 lakhs will be recognised as expense in the profit and loss account for year ended 31<sup>st</sup> March, 20X2.

#### Illustration 4

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 20X1-20X2. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs. As on 31st March, 20X2, since the said project was not complete, the directors of Take Ltd. resolved to capitalise the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

#### Solution

As per AS 13 (Revised) "Accounting for Investments", the cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. Cannot capitalise the borrowing cost as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 20X2.

#### Illustration 5

When capitalization of borrowing cost should cease as per Accounting Standard 16? Explain the provision.

#### Solution:

Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete. 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 should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

#### Illustration 6

H Ltd. incurs borrowing costs for the purpose of construction of a qualifying asset for its own use. The construction gets completed on May 31, 20X1. However, decoration work is under process which is

expected to be completed by November 20X1 after which H Ltd. will be able to start using the said asset for its own use. H Ltd. wants to capitalize the eligible borrowing costs incurred up to November 20X1.

**Solution:**

The capitalization of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying assets for its intended use or sale is completed.

In the given case, H Ltd. should capitalize borrowing costs only up to May 31, 20X1. The borrowing cost incurred thereafter cannot be capitalized as the asset was ready for its intended use on May 31, 20X1. The fact that decoration work was being carried out should not be considered as the asset was ready for its intended use on May 31, 20X1.

**Illustration 7**

ABC Ltd. is in the process of getting an entertainment park constructed. For this purpose, it has taken loan from a bank. The said park consists of several rides and facilities, each of which can be used individually. Three fourth part of the park has been constructed and can be opened up for public, while construction on the remaining part is continuing. Whether the capitalization of borrowing cost should continue for the whole park until construction continues?

**Solution:**

ABC Ltd. is in process of constructing an entertainment park which consists of several rides and facilities that can operate independently for their intended use. Even though the park as whole is not complete, the individual facilities are ready for their intended use.

The cessation of capitalization depends upon the nature of the qualifying assets, particularly where the qualifying assets consists of various parts. There are qualifying assets where each part is capable of being used while the construction continues on other parts. There are qualifying assets where all parts have to be completed before any earlier completed part can be put to use.

Since in the given scenario, the individual facilities are capable of operating independently and are ready for their intended use, therefore the borrowing costs shall cease to be capitalized for the three-fourth part of the project

**Illustration 8 (RTP May 19)**

On 1st April, 20X1, Amazing Construction Ltd. obtained a loan of ₹ 32 crores to be utilised as under:

(i)	Construction of sealink across two cities: (work was held up totally for a month during the year due to high water levels)	:	₹ 25 crores
(ii)	Purchase of equipments and machineries	:	₹ 3 crores
(iii)	Working capital	:	₹ 2 crores
(iv)	Purchase of vehicles	:	₹ 50,00,000
(v)	Advance for tools/cranes etc.	:	₹ 50,00,000
(vi)	Purchase of technical know-how	:	₹ 1 crores
(vii)	Total interest charged by the bank for the year ending 31st March, 20X2	:	₹ 80,00,000

Show the treatment of interest by Amazing Construction Ltd.

**Solution:**

According to AS 16 'Borrowing costs', qualifying asset is an asset that necessarily takes substantial period of time to get ready for its intended use.

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

The treatment of interest by Amazing Construction Ltd. can be shown as:

	Qualifying Asset	Interest to be capitalized ₹	Interest to be charged to Profit & Loss A/c ₹	
Construction of sea-link	Yes	62,50,000		[80,00,000x(25/32)]
Purchase of equipment and machineries	No		7,50,000	[80,00,000x(3/32)]
Working capital	No		5,00,000	[80,00,000x(2/32)]
Purchase of vehicles	No		1,25,000	[80,00,000x(0.5/32)]
Advance for tools, cranes etc.	No		1,25,000	[80,00,000x(0.5/32)]
Purchase of technical know-how	No		2,50,000	[80,00,000x(1/32)]
Total		62,50,000	17,50,000	

\*It is assumed that work held up for a month due to high water level is normal during the construction of sealink and capitalization of borrowing cost should not be suspended for necessary temporary delay.

### Illustration 9 (MTP March'23) (RTP Nov 20)

Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.20X1 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.20X2. Due to surplus fund out of ₹ 150 crores, income of ₹ 3.50 crores were earned and credited to profit and loss account.

Comment on the above treatment of accountant with reference to relevant AS.

(5 Marks)

#### Solution:

Para 10 of AS 16 'Borrowing Costs' states "To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings."

The capitalization rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.

Thus, the treatment of accountant of Rainbow Ltd. is incorrect.

Amount of borrowing costs capitalized should be calculated as follows:

Particulars	₹ in crores
Actual interest for 20X1-20X2 (11% of ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 20X1-20X2	13.00

### Illustration 10 (RTP Nov '22)

Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the building will be started as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year:

(₹ in lakhs)

	Phase I	Phase II	Phase III	Phase IV

	₹	₹	₹	₹
Cash expenditure	10	30	25	30
Building purchased	24	34	30	38
Total expenditure	34	64	55	68
Total expenditure of all phases				221
Loan taken @ 15% at the beginning of the year				200

During mid of the current year, Phase I and Phase II have become operational.

Find out the total amount to be capitalized and to be expensed during the year.

**Solution:**

Computation of amount to be capitalized

No.	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2.	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 +₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate	30,00,000
	Loan amount = $\frac{2,21,00,000}{3,30,317} \times 98,00,000$	(approx.)
7.	Interest on loan used for Phases III & IV, based on	16,69,683
	proportionate Loan amount = $\frac{30,00,000}{2,21,00,000} \times 1,23,00,000$	(approx.)

**Accounting treatment**

**For Phase I and Phase II**

Since Phase I and Phase II have become operational at the mid of the year, half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed during the year.

**For Phase III and Phase IV**

Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

**MTP / RTP / Past Exam****Question 1 (MTP April 21, April'22) (RTP Nov'18)**

A company incorporated in June 2020, has setup a factory within a period of 8 months with borrowed funds. The construction period of the assets had reduced drastically due to usage of technical innovations by the company and the company is able to justify the reasons for the same.

Whether interest on borrowings for the period prior to the date of setting up the factory should be capitalized although it has taken less than 12 months for the assets to get ready for use. You are required to comment on the necessary treatment with reference to AS 16. **(5 Marks)**

**Solution:**

As per AS 16 'Borrowing Costs', a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Further, the standard states that 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. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

It may be implied that there is a rebuttable presumption that a 12 months period constitutes substantial period of time.

Under present circumstances where construction period has reduced drastically due to technical innovation, the 12 months period should at best be looked at as a benchmark and not as a conclusive yardstick. It may so happen that an asset under normal circumstances may take more than 12 months to complete. However, an enterprise that completes the asset in 8 months should not be penalized for its efficiency by denying it interest capitalization and vice versa. The substantial period criteria ensures that enterprises do not spend a lot of time and effort capturing immaterial interest cost for purposes of capitalization.

Therefore, if the factory is constructed in 8 months then it shall be considered as a qualifying asset.

The interest on borrowings for the same shall be capitalised although it has taken less than 12 months for the asset to get ready to use.

**Question 2 (MTP Mar'18, Mar'19, Mar'21, Sep'22, Oct '23) (RTP May'21)**

Omega Limited has borrowed a sum of US \$ 10,00,000 at the beginning of Financial Year 2021-22 for its residential project at 4%. The interest is payable at the end of the Financial Year. At the time of availment of loan exchange rate was ₹ 56 per US \$ and the rate as on 31st March, 2022 was ₹ 62 per US \$. If Omega Limited had borrowed the loan in India in Indian Rupee equivalent, the pricing of loan would have been 10.50%.

You are required to compute Borrowing Cost and exchange difference for the year ending 31st March, 2022 as per applicable Accounting Standards **(4 Marks)**

**Solution:**

(i) Interest for the period 2021-22

$$= \text{US \$ } 10 \text{ lakhs} \times 4\% \times \text{₹ } 62 \text{ per US\$} = \text{₹ } 24.80 \text{ lakhs}$$

(ii) Increase in the liability towards the principal amount

$$= \text{US \$ } 10 \text{ lakhs} \times (\text{₹ } 62 - 56) = \text{₹ } 60 \text{ lakhs}$$

(iii) Interest that would have resulted if the loan was taken in Indian currency

$$= \text{US \$ } 10 \text{ lakhs} \times \text{₹ } 56 \times 10.5\% = \text{₹ } 58.80 \text{ lakhs}$$

(iv) Difference between interest on local currency borrowing and foreign currency borrowing

$$= ₹ 58.80 \text{ lakhs} - ₹ 24.80 \text{ lakhs} = ₹ 34 \text{ lakhs.}$$

Therefore, out of ₹ 60 lakhs increase in the liability towards principal amount, only ₹ 34 lakhs will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 58.80 lakhs being the aggregate of interest of ₹ 24.80 lakhs on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 34 lakhs.

Hence, ₹ 58.80 lakhs would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 26 lakhs (60 - 34) would be considered as the exchange difference to be accounted for as per AS 11.

**Question 3 (MTP Oct'18, Aug'18, Oct'19, Oct '22) (RTP May 20)**

Suhana Ltd. issued 12% secured debentures of ₹ 100 Lakhs on 01;05;2021, to be utilized as under:

Particulars	Amount (₹ in lakhs)
Construction of factory building	40
Purchase of Machinery	35
Working Capital	25

In March 2022, construction of the factory building was completed and machinery was installed and ready for its intended use; Total interest on debentures for the financial year ended 31;03;2022 was ₹ 11,00,000. During the year 2021-22, the company had invested idle fund out of money raised from debentures in banks' fixed deposit and had earned an interest of ₹ 2,00,000; Explain the treatment of interest under Accounting Standard 16 and also explain nature of assets. **(5 Marks)**

**Solution:**

As per AS 16 "Borrowing Costs", borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred; Also AS 16 "Borrowing Costs" states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost

$$= ₹ 11,00,000 - ₹ 2,00,000$$

$$= ₹ 9,00,000$$

Sr. No.	Particulars	Nature of assets	Interest to be Capitalized (₹)	Interest to be charged to P&L Account (₹)
i	Construction of factory building	Qualifying Asset*	$9,00,000 \times 40/100$ = ₹ 3,60,000	NIL
ii	Purchase of Machinery	Not a Qualifying Asset	NIL	$9,00,000 \times 35/100$ = ₹ 3,15,000
iii	Working Capital	Not a Qualifying Asset	NIL	$9,00,000 \times 25/100$ = ₹ 2,25,000
	Total		₹ 3,60,000	₹ 5,40,000

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

**Question 4 (MTP Nov'21, April 23)**

ABC Limited has started construction of an asset on 1st December, 2021, which continues till 31<sup>st</sup> March, 2022 (and is expected to go beyond a year). The entity has not taken any specific borrowings to finance the construction of the asset but has incurred finance costs on its general borrowings during the construction period. The directly attributable expenditure at the beginning of the month on this asset was ₹ 10 lakh in December 2021 and ₹ 4 lakh in each of the months of January to March 2022. At the beginning of the year, the entity had taken Inter Corporate Deposits of ₹ 20 lakh at 9% rate of interest and had an overdraft of ₹ 4 lakh, which increased to ₹ 8 lakh on 1st March, 2022; Interest was paid on the overdraft at 10% until 1st January, 2022 and then the rate was increased to 12%. You are required to calculate the annual capitalization rate for computation of borrowing cost in accordance with AS 16 (5 Marks)

**Solution:**

**Calculation of capitalization rate on borrowings other than specific borrowings**

Nature of general borrowings	Period of Outstanding balance	Amount of loan(Rs.)	Rate of interest p.a.	Weighted average amount of Interest (Rs.)
	a	b	c	d=[bXc]X(a/12)]
9% Debentures	12 months	20,00,000	9%	1,80,000
Bank overdraft	9 months	4,00,000	10%	30,000
	2 months	4,00,000	12%	8,000
	1 month	8,00,000	12%	8,000
		36,00,000		2,26,000

Weighted average cost of borrowings

$$=(20,00,000 \times (12/12)) + (4,00,000 \times (11/12)) + (8,00,000 \times (1/12)) = 24,33,334$$

Capitalisation rate = [(Weighted average amount of interest / Weighted average of general borrowings) x 100] = [(2,26,000 / 24,33,334) x 100] = 9.29% p.a.

**Question 5 (RTP May'18, Nov 19, Nov 21)**

In May, 2020, Omega Ltd. took a bank loan from a Bank. This loan was to be used specifically for the construction of a new factory building. The construction was completed in January, 2021 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was ₹ 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31<sup>st</sup> March, 2021 amounted to ₹ 25 lakhs. the company wants to treat ₹ 25 lakhs as part of the cost of factory building and thus capitalize it on the plea that the loan was specifically taken for the construction of factory building? Explain the treatment in line with the provisions of AS 16.

**Solution:**

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building up to the date of completion (January, 2021) i.e. ₹ 18 lakhs alone can be capitalized. It cannot be extended to ₹ 25 lakhs.

**Question 6 (RTP May '22)**

a) An enterprise has constructed a complex piece of equipment (qualifying asset) that is to be installed on the production line of a manufacturing plant. The equipment has been constructed over a period of 15

months. However, on installation, certain calibrations are required to achieve the desired level of production before it is finally commissioned. This process is expected to take approximately 2 months during which test runs will be made. Should the borrowing costs attributable to borrowings pertaining to the 2 months test run period be capitalized?

- b) Should capitalization of borrowing costs be continued when the qualifying asset has been constructed but marketing activities to sell the asset are still in progress?

**Solution:**

(a) As per AS 16 Borrowing Costs “Capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete”; On installation of the equipment, an evaluation has to be made to conclude whether substantially all the activities necessary to prepare the asset are complete. After an equipment has been installed it is usually tested and adjusted for commercial production before it is finally commissioned. The calibrations and adjustments required during this period are performed in order to bring the equipment up to the stage at which it is ready to commence commercial production. Until the asset reaches the stage when it is ready to support commercial levels of production, it is not appropriate to conclude that substantially all the activities necessary to prepare the asset are complete. Thus, the borrowing cost incurred during the normal period of test runs (after the installation) are required to be capitalized.

(b) As per provisions of AS 16, capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Further, the standard also explains that “An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user’s specification, are all that are outstanding, this indicates that substantially all the activities are complete”; The emphasis in the Standard is on “to prepare the qualifying asset for its intended use or sale” and not the actual activity of sale. Therefore, where the physical construction of the asset is complete, substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. Therefore, in the given case, the borrowing costs pertaining to the period during which the marketing activities to sell the asset are still in progress should not be capitalized as part of the cost of the asset.

**Question 7 (RTP May 23)**

Expert Limited issued 12% secured debentures of ₹ 100 lakhs on 01/06/2021; Money raised from debentures to be utilized as under:

Intended Purpose	Amount ₹ in lakhs
Construction of factory building	40
Working Capital	30
Purchase of Machinery	15
Purchase of Furniture	2
Purchase of truck	13

**Additional Information:**

Interest on debentures for the Financial Year 2021-2022 was paid by the Company.

During the year, the company invested idle fund of ₹ 5 lakhs (out of the money raised from debentures) in Bank's fixed deposit and earned interest of ₹ 50,000;

In March, 2022 construction of factory building was not completed (it is expected that it will take another 6 months).

In March 2022, Machinery was installed and ready for its intended use.

Furniture was put to use at the end of March 2022.

Truck is going to be received in April, 2022.

You are required to show the treatment of interest as per AS 16 in respect of borrowing cost for the year ended 31st March, 2022 in the Books of Expert Limited.

**Solution:**

According to AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use. As per the Standard, 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. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognized as an expense in the period in which they are incurred. It also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost = ₹ 10,00,000 (100 lakhs x 12% x 10/12) – ₹ 50,000 = ₹ 9,50,000

Particulars	Nature of assets	Interest to be capitalized (₹)	Interest to be charged to Profit & Loss Account (₹)
Construction of factory building	Qualifying Asset	9,50,000x40/100 = ₹ 3,80,000	NIL
Purchase of Machinery	Not a Qualifying Asset	NIL	9,50,000x15/100 = 1,42,500
Purchase of and furniture	Not a Qualifying Asset	NIL	9,50,000x2/100 =19,000
Purchase of truck	Not a Qualifying Asset	NIL	9,50,000x13/100 = 1,23,500
Working Capital	Not a Qualifying Asset	NIL	9,50,000x30/100 = ₹ 2,85,000
Total		₹ 3,80,000	₹ 5,70,000

**Question 8 (Past Exam Nov'20) (MTP Sep '23)**

On 15th April, 2019 RBM Ltd; obtained a Term Loan from the Bank for ₹ 320 lakhs to be utilized as under:

	₹ (in lakhs)
Construction for factory shed	240
Purchase of Machinery	30
Working capital	24
Purchase of Vehicles	12
Advance for tools/cranes etc.	8
Purchase of technical know how	6

In March, 2020 construction of shed was completed and machinery was installed. Total interest charged by the bank for the year ending 31st March, 2020 was ₹ 40 lakhs;

In the context of provisions of AS 16 'Borrowing Costs', show the treatment of interest and also explain the nature of Assets. **(5 Marks)**

**Solution:**

As per AS 16 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. 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. 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. Construction of factory shed amounting ₹ 240 lakhs is qualifying asset in the given case. The interest for this amount during the year will be added to the cost of factory shed. All others (purchase of machinery, vehicles and technical know how, working capital, advance for tools/cranes) are nonqualifying assets and related borrowing cost will be charged to Profit and Loss statement. Qualifying Asset as per AS 16 (construction of a shed) = ₹ 240 lakhs  
Borrowing cost to be capitalized = ₹ 40 lakhs x 240/320 = ₹ 30 lakhs  
Interest to be debited to Profit or Loss account: ₹ (40 – 30) = ₹ 10 lakhs;

Note: Assumed that construction of factory shed completed on 31st March, 2020.

### Question 9 (Past Exam May'19)

First Ltd. began construction of a new factory building on 1st April, 2017. It obtained Rs. 2,00,000 as a special loan to finance the construction of the factory building on 1st April, 2017 at an interest rate of 8% per annum. Further, expenditure on construction of the factory building was financed through other non-specific loans. Details of other outstanding non-specific loans were:

Amount (Rs.)	Rate of Interest per annum
4,00,000	9%
5,00,000	12%
3,00,000	14%

The expenditures that were made on the factory building construction were as follows:

Date	Amount (Rs.)
1st April, 2017	3,00,000
31st May, 2017	2,40,000
1st August, 2017	4,00,000
31st December, 2017	3,60,000

The construction of factory building was completed by 31st March, 2018. As per the provisions of AS 16, you are required to:

- Calculate the amount of interest to be capitalized.
- Pass Journal entry for capitalizing the cost & borrowing cost in respect of the factory building (5 Marks)

#### Solution:

##### (i) Computation of average accumulated expenses

		Rs.
Rs. 3,00,000 x 12 / 12	=	3,00,000
Rs. 2,40,000 x 10 / 12	=	2,00,000
Rs. 4,00,000 x 8 / 12	=	2,66,667
Rs. 3,60,000 x 3 / 12	=	90,000
		8,56,667

##### (ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (Rs. )	Rate of interest	Amount of interest (₹ )

4,00,000	9%	= 36,000
5,00,000	12%	= 60,000
3,00,000	14%	= 42,000
Weighted average rate of interest $\left(\frac{1,38,000}{12,00,000} \times 100\right)$		1,38,000
		= 11.5%

**(iii) Amount of interest to be capitalized****Interest on average accumulated expenses:**

	Rs.
Specific borrowings (Rs. 2,00,000 x 8%)	= 16,000
Non-specific borrowings (Rs. 6,56,667* x 11.5%)	= 75,517
Amount of interest to be capitalised	= 91,517

**(iv) Total expenses to be capitalized for building**

	Rs.
Cost of building Rs. (3,00,000 + 2,40,000 + 4,00,000 + 3,60,000)	13,00,000
Add: Amount of interest to be capitalized	91,517
	13,91,517

**(v) Journal Entry**

Date	Particulars	Dr. (Rs.)	Cr. (Rs.)
31.3.2018	Building A/c	Dr.	
		13,91,517	
	To Building WIP* A/c		13,00,000
	To Borrowing costs A/c		91,517
	(Being amount of cost of building and borrowing cost thereon capitalized)		

**Question 10 (Past Exam May'22)**

Zebra Limited began construction of a new plant on 1st April,2021 and obtained a special loan of ₹ 20,00,000 to finance the construction of the plant. The rate of interest on loan was 10%.

The expenditure that was incurred on the construction of plant was as follows:

	₹
1st April,2021	10,00,000
1st August,2021	24,00,000
1st January,2022	4,00,000

The company's other outstanding non-specific loan was ₹ 46,00,000 at an interest rate of 12%;

The construction of the plant completed on 31st March,2022. You are required to:

- a) Calculate the amount of interest to be capitalized as per the provisions of AS 16 "Borrowing Cost".

b) Pass a journal entry for capitalizing the cost and the borrowing cost in respect of the plant. (5 Marks)

**Solution:**

Total expenses to be capitalized for borrowings as per AS 16 "Borrowing Costs":

	₹
Cost of Plant (10,00,000 + 24,00,000 + 4,00,000)	38,00,000
Add: Amount of interest to be capitalized (W.N.)	3,24,000
	41,24,000

**Journal Entry**

		₹	₹
31st March, 2022	Plant A/c	41,24,000	
	Dr.		
	To Bank A/c		41,24,000
	[Being amount of cost of plant and borrowing cost thereon capitalized]		

**Working Note:****Computation of interest to be capitalized:**

	Expenditure			₹
1st April, 2021	10,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021	24,00,000	On specific borrowing	₹ 10,00,000 x 10%	1,00,000
1st August, 2021		On non-specific borrowings	₹ 14,00,000 × $\frac{8}{12}$ x 12%	1,12,000
1st January, 2022	4,00,000	On non-specific borrowings	₹ 4,00,000 × $\frac{8}{13}$ x 12%	12,000
				3,24,000

Alternatively, interest cost to be capitalized can be derived by computing average accumulated expenses in the following manner.

**Computation of Average Accumulated Expenses:**

1st April, 2021	10,00,000 x 12/12	10,00,000
1st August, 2021	10,00,000 x 12/12	10,00,000
	14,00,000 x 8/12	9,33,333
1st January, 2022	4,00,000 x 3/12	1,00,000
		30,33,333

**Computation of interest to be capitalized:**

		₹
On specific borrowing	₹ 20,00,000 x 10%	2,00,000
On non-specific borrowing	₹ (30,33,333- 20,00,000) x 12%	1,24,000
		3,24,000

**NOTE:** Since specific borrowings are earmarked for construction of a particular qualifying asset, it cannot be used for construction of any other qualifying asset except for temporary investment. Therefore, once the

commencement of capitalization of borrowing cost criteria are met, actual borrowing cost incurred on specific borrowing shall be capitalized irrespective of the fact that amount had been utilized in parts.

### Question 11 (Past Exam May '23)

On 1st April, 2022 Workhouse Limited took a loan from a Financial Institution for ₹ 25,00,000 for the construction of Building. The rate of interest is 12%.

In addition to above loan, the company has taken multiple borrowings as follows:

(i) 8% Debentures	₹ 15,00,000
(ii) 15% Term Loan	₹ 30,00,000
(iii) 10% Other Loans	₹ 18,00,000

The company has utilised the above funds in construction / purchase of the following assets:

(i) Building	₹ 70,00,000
(ii) Furniture	₹ 22,00,000
(iii) Plant & Machinery	₹ 90,00,000
(iv) Factory Shed	₹ 43,00,000

The construction of Building, Plant & Machinery and Factory Shed was completed on 31st March 2023. Readymade Furniture was purchased directly from the market. The factory was ready for production on 1st April 2023.

You are required to calculate the borrowing cost for both qualifying and non-qualifying assets. **(5 Marks)**

#### Solution:

Interest to be Capitalized (on qualifying asset)

	Particulars	Computation	₹
i.	On specific Borrowings	25,00,000x12%	3,00,000
ii.	On non-specific borrowings	(W.N.1)	6,67,500
iii.	Amount of interest to be Capitalised	(i+ii)	9,67,500

Interest transferred to P&L (on non-qualifying asset)

	Particulars	Computation	₹
i.	On non-specific Borrowings	(W.N.1)	82,500

#### Working note:

##### 1. Treatment of interest under AS 16 on non-specific borrowings

	Particulars	Qualifying asset	# Computation	Interest-Capitalized	Interest charged to P&L A/c
i.	Building	Yes	$45,00,000/2,00,00,000 \times 63,00,000 \times 11.9048\%$	1,68,750	-
ii.	Furniture	No	$22,00,000/2,00,00,000 \times 63,00,000 \times 11.9048\%$	-	82,500
iii.	Plant &	Yes	$90,00,000/2,00,00,000 \times 63,00,000 \times$	3,37,500	-

	Machinery		11.9048%		
iv.	Factory shed	Yes	$43,00,000/2,00,00,000 \times 63,00,000 \times 11.9048\%$	1,61,250	-
	Total			6,67,500	82,500

**NOTE:** Alternative manner of presentation for Treatment of interest under AS 16 on non-specific borrowings:

	Particulars Qualifying asset		Expenses Share in Incurred borrowings		Interest-Capitalized ₹	Interest charged to P&L A/c ₹
			₹	₹		
i.	Building	Yes	45,00,000	$7,50,000 \times 45/200$	1,68,750	-
ii.	Furniture	No	22,00,000	$7,50,000 \times 22/200$	-	82,500
iii.	Plant & Machinery	Yes	90,00,000	$7,50,000 \times 90/200$	3,37,500	-
iv.	Factory shed	Yes	43,00,000	$7,50,000 \times 43/200$	1,61,250	-
	<b>Total</b>		<b>2,00,00,000</b>		<b>6,67,500</b>	<b>82,500</b>

## 2. Weighted Average interest rate for non-specific borrowings

Particulars	Amount of loan (a)	Rate of interest (b)	Amount of interest (c) = (a) x (b)
Debentures	15,00,000	8%	1,20,000
Term loan	30,00,000	15%	4,50,000
Other loans	18,00,000	10%	1,80,000
	63,00,000		7,50,000
		# Weighted Average Rate of Interest = $7,50,000 / 63,00,000 \times 100 = 11.9048\%$	

### Question 12 (Past Exam Nov'23)

Answer the following questions:

Glen Ltd. began construction of a new building on 1st January, 2022. On 1st April, 2022, following two loans were obtained to fund the construction cost:

- Loan of ₹ 60,00,000 from Data Bank Ltd. was taken at interest rate of 8% per annum. This loan was fully utilized for construction of the new building.
- Loan of ₹ 20,00,000 from Satya Bank Ltd. Out of this, loan amount of ₹ 6,00,000 was utilized for working capital purpose. Total interest of ₹ 1,92,000 were paid to Satya Bank Ltd. for the financial year 2022-23.

Construction of the new building was completed on 31st January, 2023 and was ready for its intended use on the same date.

None of the loan was repaid during the year. The building is a qualifying asset for the purpose of AS-16.

Out of loan from Data Bank Ltd., surplus funds were temporarily invested for the short period of time. This temporary investment earned interest of ₹ 30,000.

You are required to calculate the amount of interest (a) to be capitalized, (b) to be charged to profit and loss account from the total interest incurred as borrowing cost during the year 2022-23 (as per AS-16).

**Solution:**

**(5 Marks)**

According to AS 16 "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. The amount of borrowing costs eligible for capitalization should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

The standard also states that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

Thus, eligible borrowing cost on Loan of data bank to be capitalized:

$$= ₹(60,00,000 \times 8\%) \times 10/12 - ₹30,000$$

$$= ₹4,00,000 - ₹ 30,000$$

$$= ₹3,70,000$$

Loan	Particulars	Nature of assets	(a) Interest to be Capitalized (₹)	(b) Interest to be charged to Profit & Loss Account (₹)
Data bank	Construction of factory building	Qualifying Asset	3,70,000	(4,80,000 - 4,00,000) 80,000
Satya Bank	Construction of factory building	Qualifying Asset	$(1,92,000 \times 14/20) \times 10/12 = 1,12,000$	$(1,92,000 \times 14/20) \times 2/12 = 22,400$
Satya Bank	Working Capital	Not a Qualifying Asset	NIL	$(1,92,000 \times 6/20) = ₹57,600$
	Total ₹		4,82,000	₹1,60,000

Note: Loan from Satya bank is considered to be specific borrowings.

### Question 13 (RTP Sep'24)

Loyal Ltd. has undertaken a project for expansion of capacity as per the following details:

	Plan (₹)	Actual (₹)
October, 2023	5,00,000	4,00,000
November, 2023	6,50,000	7,95,000
December, 2023	20,00,000	-
January, 2024	2,00,000	50,000
February, 2024	9,00,000	2,00,000
March, 2024	10,00,000	12,00,000

The company pays to its bank interest at a rate of 15% p.a., which is debited on a monthly basis. During the half year, company had ₹ 20 lakh overdraft up to 31st December, surplus cash in January and again overdraft of ₹ 14 lakh from 1.2.2024 and ₹ 30 lakh from 1.3.2024. The company had a strike during December and hence could not continue the work during said period. However, the substantial administrative work related to the project was continued. Onsite work was again commenced on 1st January and all the work were completed on 31<sup>st</sup> March. Assume that expenditure was incurred on 1st day of each month.

Calculate interest to be capitalized giving reason wherever necessary. Assume overdraft will be less, if there is no capital expenditure.

Solution:

## Loyal Ltd.

Month	Actual Expenditure (₹)	Interest on outstanding amount @ 15% p.a.	Interest capitalized (₹)	Outstanding amount	Cumulative amount (₹)
	1		2	3	
October, 2023	4,00,000	4,00,000*15%*1/12	5,000	4,05,000	4,05,000
November, 2023	7,95,000	(4,05,000 + 7,95,000)*15%*1/12	15,000	(4,05,000 + 7,95,000 + 15,000)	12,15,000
December, 2023	-	(12,15,000)*15%*1/12	15,188	12,15,000 + 15,188	12,30,188
January, 2024	50,000		-	12,30,188 + 50,000	12,80,188
February, 2024	2,00,000	14,00,000*15%*1/12	17,500	12,80,188 + 2,00,000 + 17,500	14,97,688
March, 2024	12,00,000	(14,97,688 + 12,00,000)*15%*1/12	33,721	14,97,688 + 12,00,000 + 33,721	27,31,409
	26,45,000		86,409		

Note:

- 1) As per para 18 of AS 16, 'Borrowing Cost', capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Therefore, the interest for that period i.e. for the month of December has also been capitalized.
- 2) During January, the company did not incur any interest as there was surplus cash in January. Therefore, no amount should be capitalized during January as per para 14(b) of AS 16.
- 3) During February, actual overdraft (borrowings) was ₹ 14 lakh only. Hence, interest of ₹ 17,500 on ₹ 14,00,000 has been calculated even though actual expenditure on project exceed ₹ 14 lakh.

**MCQ**

1. As per AS 16, all the following are qualifying assets except

- (a) Manufacturing plants and Power generation facilities
- (b) Inventories that require substantial period of time
- (c) Assets those are ready for sale.
- (d) None of the above

2. Which of the following statement is correct:

- (a) Entire exchange gain is reduced from the cost of the Qualifying asset.
- (b) Entire exchange loss is added to the cost of a Qualifying asset.
- (c) No adjustment is done for the exchange loss while computing cost of Qualifying asset.
- (d) None of the above

3. Capitalisation rate considers:

- (a) Borrowing costs on general borrowings only.
- (b) Borrowing costs on general and specific borrowings both.
- (c) Borrowing costs on specific borrowings only
- (d) None of the above

4. If the amount eligible for capitalisation in case of inventory as per AS 16 is ₹ 12,000 and cost of inventory is ₹ 40,000 and its net realizable value is ₹ 45,000; What amount can be capitalised as a part of inventory cost.

- (a) ₹ 12,000.
- (b) ₹ 5,000.
- (c) ₹ 7,000.
- (c) ₹ 10,000.

5. X Ltd is commencing a new construction project, which is to be financed by borrowing. The key dates are as follows:

- (i) 15th May, 20X1: Loan interest relating to the project starts to be incurred
- (ii) 2nd June, 20X1: Technical site planning commences
- (iii) 19th June, 20X1: Expenditure on the project started to be incurred
- (iv) 18th July, 20X1: Construction work commences

Identify the commencement date for capitalisation under AS 16.

- (a) 15th May, 20X1.
- (b) 19th June, 20X1.
- (c) 18th July, 20X1.
- (d) 2nd June, 20X1

**/SOLUTIONS****MCQs**

1. (c) 2. (c) 3. (a) 4. (b) 5. (b)