CFA INSTITUTE | Centre for Financial Market Integrity

19 July 2006

Sir David Tweedie
Chair, International Accounting Standards Board
30 Cannon Street
London EC4M 6Xh
United Kingdom

Re: Exposure Draft – Amendments to IAS 23 Borrowing Costs

Dear Sir David:

The CFA Centre for Financial Market Integrity (CFA Centre) of CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB") Exposure Draft of Proposed Amendments to IAS 23, *Borrowing Costs* ("ED"). The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

General Comments

We do not support the Board's proposed amendments to IAS 23, Borrowing Costs. We have had a long-standing position that borrowing costs should not be capitalized. In our comment letter to the International Accounting Standards Committee dated November 8, 1991 (ATTACHMENT A), we noted that capitalizing borrowing costs will cause the carrying amounts of assets to be determined based on the financial structure of a firm. As a result, the accounting treatment of the cost of capital will vary between firms depending on whether they decide to use debt rather than equity to fund the acquisition, construction or production of a qualifying asset.

[1] The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 83,000 financial analysts, portfolio managers, and other investment professionals located in 129 countries of which more than 68,000 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 134 affiliated Member Societies and Chapters in 55 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council comprises individuals, who are investment professionals with extensive expertise and experience in the global capital markets, as well as CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures which meet the needs of investors.

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Expensing Borrowing Costs is the Appropriate Accounting Treatment

Generally, we do not support options or alternative accounting treatments for economically similar business transactions and/or activities. Many standards under IFRS and U.S GAAP permit financial reporting choices and thus, allow managers to report similar items in very different ways resulting in financial statements which are difficult to compare and analyze. Therefore, we support the elimination of accounting options. However, with regard to this ED, we firmly believe that the Board has chosen to eliminate the most appropriate accounting treatment, which is to expense borrowing costs in the reporting period in which they are incurred.

Given the Board's recent proposal to amend IFRS 3 *Business Combinations*, we are surprised that it would support eliminating expensing borrowing costs. We realize that the underlying measurement attribute for business combinations is fair value. Consequently, the proposed amendments to IFRS 3 would require the expensing of transaction costs because they are entity specific and do not affect the underlying value of the asset acquired. We believe that similar reasoning should also apply to borrowing costs. The accumulated costs measurement basis should not be considered an appropriate way to determine the value of an asset. It does not have the same predictive quality [regarding expected future cash flows] as a fair value measurement.

Disagreement with the Basis for Amending IAS 23

In the Basis for Conclusions, paragraph B2, the primary basis for eliminating the option to expense borrowing costs is to improve the comparability of financial statements and to converge with U.S. GAAP.

To Improve the Comparability of Financial Statements

With regard to this ED, the Board views the enhancement of comparability as an improvement to financial reporting. However, we question this conclusion in that it appears to contradict the IASB's Framework regarding the qualitative characteristics that make the information provided in financial statements useful to investors, creditors and other users. In particular, paragraph 41 of the Framework states the following about comparability –

> 41. ***The need for comparability should not be confused with mere uniformity*** [or in this circumstance, convergence between two sets of standards] ***and should not be allowed to become an impediment to the introduction of improved accounting standards***. *It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if* ***the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability***. *It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.* **[Emphasis added.]**

To Converge with U.S. GAAP

Overall, we are strong supporters of the IASB's and FASB's efforts to converge IFRS and U.S. GAAP. As users of financial statements, we support the joint projects underway to improve the quality of global financial reporting. However, we are troubled by some of the IASB's decisions to converge standards such as IAS 14 *Segment Reporting* and now, IAS 23 *Borrowing Costs* with existing U.S. GAAP. The current proposed amendments to these standards do not appear to consider completely a key objective of the IASB, which is *to bring about convergence with national accounting standards and IFRS to* <u>*high quality solutions*</u>*.*

We understand that the ED is part of the Board's short-term convergence efforts because it is viewed as an easy solution to existing differences between IFRS and U.S. GAAP. The solution appears simple because currently IAS 23 has one more accounting option than SFAS 34, which is expensing borrowing costs. Since convergence and comparability are driving the proposed amendments, an appropriate solution appears to be the elimination of the option causing the accounting difference, or in this case, expensing borrowing costs.

However, we challenge this view because we believe that it does not promote changes in financial reporting which are in the best interests of users of financial statements. Instead of a "quick fix," we believe strongly that standards such as IAS 23 and SFAS 34 should be overhauled and updated to incorporate more current thinking and Board deliberations. SFAS 34 was issued more than 25 years ago and at the time was marginal in that three of the seven FASB members dissented from issuing this standard. The dissenting members noted –

> *Messrs. Block, Kirk, and Morgan consider interest to be a cost of a different order from the costs of materials, labor, and other services in two respects.* ***First****, cash—the resource obtained by the payment of interest on debt—has unique characteristics. It is fungible. It is obtained from a variety of sources (principally, earning activities, borrowings, issuance of equity securities, and sales of economic resources), only one of which (borrowings) gives rise to a cost that is recognized in the present accounting framework. The amount of cash (or cash equivalent) given in exchange for a noncash resource provides the basis for measuring the cost of a noncash resource. Because of those characteristics of cash, interest on debt cannot be assigned or allocated to noncash resources in the same way as material, labor, and overhead costs, and association of interest on debt with a particular category of noncash resources, such as assets undergoing a construction or production process, is inherently arbitrary.* <u>***Second****, interest cost is the return to lenders on capital provided by them to an enterprise for a certain period. In the view of Messrs. Block, Kirk, and Morgan, interest cost, like dividends, is more directly associable with the period during which the capital giving rise to it is outstanding than with the material, labor, and other resources into which capital is converted.*</u> *They acknowledge that the conversion of cash into a nonearning asset entails the sacrifice of the return that the cash could otherwise have*

> *earned, but they do not believe that a measure of that sacrifice is a proper addition to the cost of acquiring the asset. In addition, they note that, by attaching an interest cost to all expenditures for a qualifying asset, the prescribed method in this Statement in effect imputes an interest cost to any equity funds that may have been used for it. [Emphasis added.]*

We believe that fair value measurement is more relevant in predicting the future cash flows and ultimately the value of a firm. While the fair value of an asset may have financing costs embedded in it, such costs (however computed) are not accounted for separately. Capitalization of interest makes sense only in the "cost accumulation" model that is, we believe, obsolete as an appropriate measurement basis.

Response to Questions Asked in the Exposure Draft

Question 1

This Exposure Draft proposes to eliminate the option in IAS 23 of recognizing 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?

No, we do not agree with the proposal. Under this ED and SFAS 34, borrowing costs are only capitalized if the firm is leveraged. We do not believe that it is logical to have similar assets carried at different costs based on a firm's decision to finance the asset's construction with debt rather than equity. Further, capitalization of borrowing costs results in unnecessary complexity in financial reporting, i.e., the creation of differences between reported earnings and cash flows depending on the financial structure of the firm.

Currently, candidates preparing for the CFA® exam are instructed to make the following adjustments as part of their analysis of a firm's financial statements:[3]

1. *Capitalized interest should be added back to interest expense.* The adjusted interest expense provides a better presentation of the level and trend of a firm's financing costs**.**
2. *Adding capitalized interest back to interest expense reduces net income.* Unfortunately, although the amount of interest capitalized in the current year must be disclosed, disclosure of the amortization of previously capitalized interest (included in the fixed asset account) is not required and is rarely provided. This amortization must be

[3] White, Gerald I., CFA, Ashwinpaul C. Sondhi, and Dov Fried, *The Analysis and Use of Financial Statements*, Third Edition, Wiley (New York), 2003, pp. 233-235.

deducted from depreciation expense to accurately determine the net effect of interest capitalization on net income. *However, if the amount of interest capitalization in previous years is not large and asset lives are long, the amortization (over the asset life) is likely to be immaterial and can be ignored.* If amortization has been large, the analyst must estimate the amortization.

3. *The capitalization of interest also distorts the classification of cash flows. Interest capitalized as part of the cost of fixed assets will never be reported as CFO [Cash from Operations], but as an investment outflow. To restore comparability with firms that do not capitalize interest, the amount of interest capitalized should be added back to cash for investment and subtracted from CFO.* The cash flows for capitalized interest are then included with other interest payments.
4. *The interest coverage ratio should be calculated with interest expense adjusted to add back capitalized interest.* Otherwise, it is overstated.

Question 2

This Exposure Draft proposes that entities should apply the amendments to borrowing costs for which the commencement date for capitalization 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 capitalization is on or after that date. Do you agree with the proposal? If not, why? What alternative would you propose and why?

No comment. (Please refer to our response to **Question 1**.)

Closing Remarks

Overall, we are disappointed that the Board has again decided to amend existing IFRS for the sake of converging with U.S. GAAP. Although we support the effort to converge international accounting standards, such as U.S. GAAP and IFRS, we do not believe that expediency and convenience should drive changes to financial reporting. Convergence alone will not result in the overall improvement of the global financial reporting.

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comments to the IASB on its proposed amendments to IAS 23, *Borrowing Costs*. If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

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Our comments have benefited from, and are supported by, the substantive input of the Corporate Disclosure Policy Council. The members of the Council are:

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