Comments and suggestions on the IPSASB Proposals of ED74

"IPSAS 5, Borrowing Costs – Non-Authoritative Guidance"

Task force IRSPM A&A SIG, CIGAR Network, EGPA PSG XII

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The IPSASB has requested comments and answers to specific questions regarding its Exposure Draft 74, which proposes adding non-authoritative material to IPSAS 5, Borrowing Costs. The addition is meant to provide guidance for determining the extent to which borrowing costs can be capitalized.

The comments and responses prepared by the Task Force IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are presented below.

The IRSPM A&A SIG, CIGAR Network and EGPA PSG XII are three research networks that focus on Public Sector Accounting. The Task Force is made up of 18 researchers from these networks. The views expressed in this document represent those of the members of the Task Force and not of the whole research community represented by the networks, and neither of the Institutions/Universities with which they are affiliated.

Comments and suggestions considering the IPSASB document for ED 74 'IPSAS 5, Borrowing Costs – Non-Authoritative Guidance'

We welcome the opportunity to comment on the proposed addition of non-authoritative material to IPSAS 5, Borrowing Costs, contained in ED 74. We see the development of standards and guidance on matters that are specific to the public sector as being a particularly important part of the continuing programme of work of the IPSASB. Therefore, our comments are meant to contribute to a clearer explanation of examples and guidance.

Core assumptions

We are of the opinion that Public Financial Management (PFM), in its broadest sense, is the system by which public financial resources are planned, managed, and controlled. Furthermore, the PFM system is the foundation on which the accountability of public sector entities, both external and internal, is built to enable and influence the efficient and effective delivery of public service outcomes and to discharge accountability towards citizens. In our view, PFM is paramount for accountability and should support the stewardship and decision-making functions, which are both subordinated. We recognise the pivotal role of the Board in developing high quality international public sector accounting standards to support financial reporting and to enhance non-financial disclosure by public sector entities to increase citizens' trust.

We are of the opinion that, in general, public sector entities require public sector specific principles and standards that properly address and accommodate public sector specificities. As such, when public sector transactions resemble those taking place in the private sector, principles and standards may be kept as aligned as possible. However, for public-sector-specific transactions, we are in favour of standards that are not adapted artificially from private sector accounting and we think there is a need to seek options that best fit the public sector. This core thesis underpins our proposals and recommendations within which we have sought to embed issues raised in academic works.

Finally we welcome the development of additional implementation guidance and illustrative examples by IPSASB. As it is shown by our answers, the practical details are important. Some theoretically stated considerations in the Standards can give rise to different interpretations and suggestions when applied in practice.

Specific Matter for Comment 1

Do you agree with the proposed additional implementation guidance and illustrative examples? If not, what changes would you make?

Response:

We agree with the proposed additional implementation guidance and illustrative examples.

We have a few comments and suggestions, which we hope may be helpful for the Board in order to finalize the document.

The Exposure Draft helps disentangling the difficulties that public sector entities may encounter in the capitalization of borrowing costs.

As a matter of fact, previous consultations underlined issues in accounting for borrowing costs, especially: a) the circumstance for which borrowing is often centralized in the public sector and determined for the economic entity as a whole; b) the difficulties of attributing the borrowing costs to specific projects when multiple funding sources are used.

These concerns are addressed by the Implementation Guidance contained in "A.3 Asset Funded through Transfers" and "A.4 Asset Funded through a Centralized Lending Program – Interest Rates", which explain how public sector entities can determine the amount of borrowing costs eligible for capitalization when funds are transferred from other public sector entities or gathered from multiple sources.

Other issues are dealt with in the other parts of the Implementation Guidance section.

Illustrative Examples provide useful clarifications about the extent to which borrowing costs can be capitalized. With particular regard to the issues highlighted above, these are addressed by Illustrative Examples numbered IE4 to IE15.

The four examples contained in the Illustrative Examples section cover paragraph 22 (IE4-IE8), paragraphs 23-24 (IE1-IE3), and paragraph 25 (IE9-IE12) of IPSAS 5. Especially the illustrative examples covering paragraph 25 of IPSAS 5 focus on the calculation of the average cost of borrowing and the cost of borrowing when there is specific borrowing for an asset. However, it would be useful to develop a different example, with multiple investments taking place under an entity's general borrowing and financed from several origins (borrowing, tax revenue and other fees and transfers), in which the allocation to them of capitalized expenses complies with the constraint of the amount of borrowing costs capitalized during a period not exceeding the amount of borrowing costs incurred during that period.

Nevertheless we would like to express concerns and suggestions especially to two major points:

(a) Implementation Guidance contained in "A.1 Period of Borrowing Cost Capitalization" and
(b) Implementation Guidance contained in "A.2 Limit on Capitalization" and the complementing Illustrative Example "Qualifying Asset Constructed Over a Period of Time" (IE1-IE3).

Ad a) Implementation Guidance contained in "A.1 Period of Borrowing Cost Capitalization"

An issue remains that may represent an obstacle for public sector entities wishing to recognize borrowing costs according to the Allowed Alternative Treatment of IPSAS 5, i.e. the period of borrowing cost capitalization. This issue is well recalled in the Implementation Guidance contained in "A.1 Period of Borrowing Cost Capitalization", but no Illustrative Example is provided to this regard. The implementation guidance focuses only on the beginning of activities necessary to get the asset ready for use, but remains vague. No examples of such activities are provided. Furthermore, other cumulative preconditions for capitalizing borrowing costs are missing.

Pursuant paragraph 31 of IPSAS 5, "The capitalization of borrowing costs as part of the cost of a qualifying asset should commence when: (a) Outlays for the asset are being incurred; (b) Borrowing costs are being incurred; and (c) Activities that are necessary to prepare the asset for its intended use or sale are in progress". Considering that acquisition, construction, or production in the public sector mostly begin through staged processes (e.g. public procurement), it may be useful to extend the Implementation Guidance contained in "A.1 Period of Borrowing Cost Capitalization" and complement it with an Illustrative Example for each of the commencement conditions listed in paragraph 31 of IPSAS 5.

Ad b): Implementation Guidance contained in "A.2 Limit on Capitalization" and the complementing Illustrative Example "Qualifying Asset Constructed Over a Period of Time" (IE1-IE3)

A.2 and the complementing Illustrative Example explain the procedure of calculating the maximum amount eligible for capitalization. The term "limit" in connection with "when applying the allowed alternative treatment" might express that the capitalized amount might be lower, if the entity applies a different accounting policy with respect to those cases covered by the illustrative example. The special feature of the example given is that the borrowing and its utilisation by the qualifying asset differ. We will elaborate this alternative accounting policy with respect to the Illustrative Example "Qualifying Asset Constructed Over a Period of Time" (IE1-IE3) in the following. The rationale behind the alternative accounting policy is based on IPSAS 5.21 ("The borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset are those borrowing costs that would have been avoided if the outlays on the qualifying asset had not been made.")

The Illustrative Example "Qualifying Asset Constructed Over a Period of Time" (IE1-IE3) explains how the maximum amount of borrowing costs eligible for capitalization is calculated for the first period, starting on March 31) (i.e. the first nine months) of the whole construction period. When applying this accounting policy procedure for the whole construction period of five years, ending on March 31 of the sixth period, we calculate the following: borrowing costs (CU25 million) less temporary investment revenues (CU6 million) sum up to CU19 million, thus raising acquisition, construction, or production costs from 5xCU20 million to CU119 million. This increase in costs also raises the risk of an impairment loss.

A different accounting policy, limiting the borrowing costs to the funding of the outlays incurred (CU20 million in the 2nd, 3rd, 4th quarter of the first period; CU20 million for the 1st and CU40 million for the remaining quarters in period 2, etc.) can lower this risk and could be considered by the entity to be more appropriate if the government was not forced by legislation to borrow in excess "to show it was able to secure financing" (IE13). In other words, if excess borrowing is not due to compliance with existing regulations, but to the borrowing government's inefficiency, the following two exemplary accounting policies might be applied voluntarily, limiting the capitalization to the borrowing costs for expenses incurred for the acquisition, production or construction of a qualifying asset.

- The first alternative might follow the general rule, to capitalize the directly attributable amount of borrowing costs and reduce it by income on temporary investments on excess funding, e.g. unused funds.
- The second alternative might renounce deducting the income on temporary investments for consistency reasons: as excess borrowing costs are not capitalized, income on the corresponding temporary investment might not be deducted from capitalisation.

Therefore, we also propose to add a clarification if less than the maximum amount might be capitalized. Finally, as the example expands to a 25-year period, we suggest that for illustration purposes the example covers the whole period under analysis.

To the same backdrop, we encourage the IPSASB to add Illustrative Examples:

- covering paragraphs 34-35 on Suspension of Capitalization;
- about the distinction between borrowing costs and transaction costs (see BC 13 and BC 14);
- covering the Implementation Guidance A.4, referring to assets funded through a Centralised Lending Program - more specifically about the capitalisation of borrowing costs based on market interest rates when concessional terms are identified.

Comments on other matters discussed in this Exposure Draft

There are some minor issues which we suggest the Board should pay attention to. We list them below.

1. The Exposure Draft introduces twelve new points in the Basis for Conclusions of IPSAS 5, with numbers BC3 to BC 14. As a matter of fact, the 2020 Edition of the IPSAS Handbook, page 327, reports BC3 already exists, so we wonder if the correct numbering for the additional Basis for Conclusions should read BC4 to BC 15. Should this be the case, the amendment ought to concern both the Summary, at page 5 of

ED74, and the actual Basis for Conclusions, pages 6-8 of ED 74.

2. IE15 complements IE13 and IE14, but does not really add significant points. It seems therefore redundant. A more interesting remark, in this example, would be to recall the reader's attention on the fact that the federal grant is not relevant in this case, and to repeat the reasons thereof.
3. In IE9, it reads "State Government T manages its own borrowings; however, it does not borrow for specific projects". We believe that it should be made explicit that the borrowings is related only to investments and not operating or other activities.

Date: 1 March, 2021 Signed on behalf of those persons listed below

Caroline	Aggestam Pontopiddan	Associate Professor of Accounting	Copenhagen Business School, Denmark
Eugenio	Anessi Pessina	Professor of Public Management	Università Cattolica del Sacro Cuore, Milan, Italy
Natalia	Aversano	Associate Professor of Accounting	University of Salerno, Italy
Yuri	Biondi	Senior Tenured Research Fellow of the CNRS	IRISSO, University Paris Dauphine PSL, France
Marco	Bisogno	Associate Professor of Accounting	University of Salerno, Italy
Isabel	Brusca	Professor of Accounting and Finance	University of Zaragoza, Spain
Eugenio	Caperchione	Professor of Public Management	University of Modena and Reggio Emilia, Italy
Josette	Caruana	FCCA, FIA, CPA, MA (Fin. Services), PhD	Lecturer, Department of Accountancy, University of Malta, Malta
Johan	Christiaens	Professor of Public Sector Accounting and Auditing, CPA	Ghent University, Belgium
Sandra	Cohen	Professor of Accounting	Athens University of Economics and Business, Greece
Giovanna	Dabbicco	Researcher, and Adjunct Assistant Professor	ISTAT - Italian National Institute of Statistics, Italy
Ellen	Haustein	Lecturer and Scientific Researcher of Accounting, Management Control and Auditing	University of Rostock, Germany
Susana	Jorge	Tenured Professor with accreditation	University of Coimbra, Portugal
Peter Christoph	Lorson	Professor of Accounting, Management Control and Auditing	University of Rostock, Germany
Francesca	Manes Rossi	Associate Professor of Accounting, CPA	University of Naples Federico II, Italy
Christoph	Reichard	Professor Emeritus of Public Management	University of Potsdam, Germany
Mariafrancesca	Sicilia	Associate Professor of Public Sector Management and Accounting	University of Bergamo, Italy
Ileana	Steccolini	Professor of Accounting and Finance	Essex University, U.K.