

**Technical uncertainties in and practical implications of the  
capitalisation of borrowing costs in South Africa**

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## **List of abbreviations**

CPD	Continuing professional development
CIMA	Chartered Institute of Management Accountants
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles/Practices
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
SAICA	South African Institute of Chartered Accountants
SAIPA	South African Institute of Professional Accountants
SFAS	Statement of Financial Accounting Standards
US GAAP	United States Generally Accepted Accounting Principles

## Dissertation summary

**Title:** Technical uncertainties in and practical implications of the capitalisation of borrowing costs in South Africa

**Key terms:** Borrowing costs, capitalisation, International Accounting Standards (IAS), Statement of Financial Accounting Standards (SFAS), International Accounting Standards Board (IASB), International Financial Reporting Standards (IFRS), qualifying assets, convergence, United States Generally Accepted Accounting Principles (US GAAP), interest, technical uncertainties, IAS 23, SFAS 34.

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The International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB) have reaffirmed their commitment to accomplishing the convergence of International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Practice (US GAAP), following their March 2010 progress report. Among the standards subject to this convergence project, is IAS 23 – Borrowing Costs. Taken at face value, the convergence of IAS 23 (IFRS) and SFAS 34 (US GAAP), and looking at convergence in general, the idea is productive and beneficial. It will lead to more comparative information as it eliminates the differences. The downside, however, could very easily be that convergence might just be taking place for the sake of convergence, and that the end result might not necessarily lead to more comparative and cost effective information. When specifically considering the convergence of the two borrowing costs standards (SFAS 34 and IAS 23), it is clear that differences remain even after their convergence, and therefore it does not promote comparability. The revision of IAS 23 might actually have been more costly and less beneficial, rather than the other way around. The first article in this dissertation claims that the mandatory capitalisation of borrowing costs is more costly than not, and that the IASB did not adequately consider the cost implications in their decision to change IAS 23, as well as that the benefits obtained from the capitalisation of borrowing costs are not that noticeable in practice. Participants in this study also seemed to agree that the application of IAS 23 is fairly difficult. Delving deeper into the technical aspects of IAS 23, a number of questions also arise relating to its application. This appears to be substantiated by the findings in the second article where instances were identified where the opinions of the participants relating to, for instance, what would be regarded as a ‘substantial period of time’, were divided. Differences relating to the above

may lead to one person capitalising borrowing costs, while another in the same situation would not. On the upside, a few instances were identified where participants were not as divided in their views. Therefore, although there appear to be some uncertainties within IAS 23, there are fewer than one would have expected.

In summary, the revised IAS 23, in other words, the mandatory capitalisation of borrowing costs on qualifying assets, was viewed by participants as being more costly and difficult to apply than not and they felt that some technical uncertainties do exist within IAS 23. Recommendations have been made in this dissertation based on the useful information obtained.

## Verhandeling-opsomming

**Titel:** Tegniese onsekerhede in en praktiese implikasies van die kapitalisering van leenkoste in Suid-Afrika.

**Sleuteltermes:** Leenkoste, kapitalisering, International Accounting Standards (IAS), Statement of Financial Accounting Standards, (SFAS) International Accounting Standards Board (IASB), International Financial Reporting Standards (IFRS), kwalifiserende bates, harmoniëring, United States Generally Accepted Accounting Principles (US GAAP), rente, tegniese onsekerhede, IAS 23, SFAS 34.

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Die International Accounting Standards Board (IASB) en die Financial Accounting Standards Board (FASB) het hul verbintenis tot die harmoniëring van die International Financial Reporting Standards (IFRS) en US Generally Accepted Accounting Practice (US GAAP) herbevestig na die Maart 2010 vorderingsverslag. Een van die standaarde wat onderhewig is aan die harmoniëring is, onder andere, IAS 23 – Leenkoste. Die idee van harmoniëring van IAS 23 (IFRS) en SFAS 34 (US GAAP), asook harmoniëring in die algemeen, is produktief en voordelig. Dit sal lei tot meer vergelykbare inligting omdat dit verskille elimineer. Die minder positiewe kant daarvan kan egter baie maklik wees dat harmoniëring slegs plaasvind ter wille van harmoniëring en dat die eindresultaat nie noodwendig sal lei tot meer vergelykbare en kostedoeltreffende inligting nie. As daar spesifiek gekyk word na die harmoniëring van die twee standaarde oor Leenkoste (SFAS 34 en IAS 23), is dit duidelik dat daar steeds verskille agterweë gebly het selfs na die harmoniëring en daarom word vergelykbaarheid nie in dié geval bevorder nie. Dit is dus moontlik dat die hersiening van IAS 23 nie kostedoeltreffend was nie en ook nie so voordelig nie, eerder as andersom. Die eerste artikel in die verhandeling beweer dat die verpligte kapitalisering van leenkoste minder kostedoeltreffend is eerder as meer doeltreffend, en dat die IASB nie genoegsame oorweging geskenk het aan die koste-implikasies van hul besluit om IAS 23 te hersien nie, en dat die voordele verkry vanuit kapitalisering nie so merkbaar in die praktyk is nie. Deelnemers aan die studie het ook saamgestem dat die toepassing van IAS 23 redelik moeilik is. Indien daar dieper gedelf word in die tegniese aspekte van IAS 23, is daar 'n aantal vrae wat ontstaan oor die toepassing van die standaard. Dit blyk bevestig te word deur die bevindings van die tweede artikel waar gevalle geïdentifiseer is waar die opinies van deelnemers met betrekking tot, byvoorbeeld, wat deelnemers beskou as 'n wesentlike periode, verdeeld was. Verskille rakende die bogenoemde kan daartoe lei dat

een persoon leenkoste kapitaliseer, terwyl 'n ander persoon in dieselfde omstandighede nie sal kapitaliseer nie. In 'n positiewer lig, was daar ook 'n aantal gevalle waar deelnemers eensgesind was in hul opinies. Gevolglik, alhoewel daar wel 'n paar onsekerhede binne IAS 23 is, is daar minder as wat verwag is.

Ter opsomming word die hersiene IAS 23, met ander woorde die verpligte kapitalisering van leenkoste op kwalifiserende bates, deur deelnemers gesien as minder kostedoeltreffend en moeiliker om toe te pas, en hulle het gevoel dat daar wel sommige onsekerhede in IAS 23 bestaan. Aanbevelings is in hierdie verhandeling gemaak gebaseer op die waardevolle inligting wat ingewin is.

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- To my parents, who encouraged me to do what I believed was right for me.

## **Remarks**

The reader is reminded of the following:

This dissertation is presented in the article format in accordance with the policies of the North-West University's faculty of Economic and Management Sciences' WorkWell Research Unit and consists of two research articles.

Each of the individual articles comply with the writing style requirements (i.e. the specific abstract, spelling, grammar and referencing requirements) of the specific journal to which the specific article was submitted.

The author requirements and related documentation specific to each journal, are included as part of the annexure at the end of the dissertation.

# *Chapter 1*

## *Purpose, scope and extent of the study*

# 1. Introduction

In South Africa, International Financial Reporting Standards (IFRS) as well as International Accounting Standards (IAS), which are part of IFRS, are used as a guideline for the composition of financial statements (Everingham, Kleynhans & Posthumus, 2007:2-3); thus the South African standards closely resemble IFRS today (Vorster, Koornhof, Oberholster, Koppeschaar, Coetzee, Janse van Rensburg, Binnekade, Leith, Hattingh & De Klerk, 2009:1-2).

Fairly recently, the IFRS standard on borrowing costs (IAS 23) was described by Enslin (2008:22) as a standard not accorded much attention by students during their time of study, except for a short overview for fear of a question in an examination. The reason for this is probably because the capitalisation of borrowing costs was only an allowed alternative according to the standard, and that the 'income statement approach', whereby borrowing costs were expensed in profit or loss (which is a more elementary approach), was the norm.

The definition of borrowing costs according to IAS 23 is: "interest and other costs an entity incurs in relation to the borrowing of funds" (International Accounting Standards Board, 2009b:1428). The standard also extends this definition by furnishing a list of costs which are included in borrowing costs. According to the International Accounting Standards Board (2009b:1428), these include the following:

- Interest on bank overdrafts and short-term and long term loans.
- Finance costs recognised according to IAS 17 (the standard on leases).
- Exchange rate differences originating from foreign currency loans as far as they are related to an adjustment to interest cost.

According to Enslin (2008:22), in practice, little attention has been paid to capitalisation of borrowing costs since the choice was always available to either capitalise borrowing costs or to recognise the costs directly in profit or loss (the income statement approach). However, the above situation changed in August 2007. The choice in the accounting treatment was completely erased and borrowing costs incurred on certain 'qualifying assets' have to be capitalised, effective for financial periods beginning on or after 1 January 2009 (Enslin, 2008:22). IAS 23 defines a qualifying asset as an asset which necessarily takes a substantial period of time to be prepared for the intended use or sale thereof (International Accounting Standards Board, 2009b:1428). According to Vorster *et al.* (2009:511) and the International Accounting Standards Board (2009b:1430), borrowing costs can be incurred on loans specifically incurred regarding qualifying

assets or on a pool of loans (general loans) where it is too difficult to directly attribute the loan(s) to a qualifying asset. The portion that has to be capitalised is the portion which would have been avoided had the qualifying asset not been erected. For specific loans, the outstanding amount is multiplied by the specific rate of the loan. However, when general loans are used, the weighted average borrowing rate is multiplied by the expenditure incurred on the qualifying asset.

Before the revision of IAS 23, certain companies had already selected a voluntary policy of capitalisation of borrowing costs instead of the income statement approach, and thus these companies should not experience major problems with the requirements of the revised IAS 23 (Enslin, 2008:22). However, companies which followed the income statement approach might experience a variety of problems and practical difficulties with the implementation of the new requirements. According to Ernst & Young (2006), it would seem that companies that had previously used the income statement approach are in the majority, which might explain why very little attention was paid to the practical application of the capitalisation of borrowing costs in the past. The revision of IAS 23 will necessitate an in-depth look into certain requirements of IAS 23, and policies will have to be developed regarding certain grey areas existing in the standard (Enslin, 2008:22). Nestlé S.A. (2006) also made the statement that IAS 23 does not properly address the practical matters related to the capitalisation of borrowing costs, especially in multi-national groups.

## **2. Motivation and problem statement**

The main reason for the changes to IAS 23, according to Gornik-Tomaszewski (2003:39), is to aim for the reduction of the differences between the IFRS and the United States Generally Accepted Accounting Principles (US GAAP). The initiative is called the Short-term Convergence Project and will enable the removal of a variety of individual differences between the US GAAP and IFRS in an attempt to enhance the quality and consistency of financial reporting between entities from different countries. The IASB proposed that certain choices in the accounting treatment of specific matters and conflicts between standards be eliminated. The IASB's argument is that the application of only one method, instead of a choice between two methods, will improve the compatibility of financial statements. However, the question that arises is whether the benefits resulting from the compatibility will surpass the costs needed to achieve such compatibility.

SFAS 34 is the US GAAP standard which addresses the treatment of borrowing costs. In the agenda of the IASB's meeting held in November 2005, it was noted that SFAS 34 is not seen as being of a higher quality than IAS 23. In November 2006, at a successive meeting, it was also noted in the

agenda that the intention of the revision of IAS 23 was to improve the standard rather than to obtain the ‘right’ answer (International Accounting Standards Board, 2008:3).

SFAS 34 and IAS 23 are however still different in many ways, even after the so-called ‘convergence’. According to the International Accounting Standards Board (2007:1-2), a few of these remaining differences are:

- The definition of a qualifying asset differs. IAS 23 uses the word “substantial”; in other words the asset should take a considerable period to be prepared for the use thereof. SFAS 34 does not mention the duration of the period.
- IAS 23 uses the term “borrowing cost”, which is a wider concept than the term used by SFAS 34, namely “interest cost”. Therefore a difference may exist in the type of costs which can be capitalised.
- IAS 23 excludes assets carried at fair value from its scope, while SFAS 34 does not mention these types of assets.
- In relation to specific loans, IAS 23 requires that interest income earned on unutilised funds be deducted from borrowing costs when calculating the amount to be capitalised. SFAS 34 does not allow this treatment.
- SFAS 34 determines that judgement may be used by the applier of IAS 23 in determining the capitalisation rate. IAS 23 requires that all outstanding debt, except specific debt, be used to determine the rate.

The above-mentioned are only some of the differences that still exist. The conclusion at which one might arrive is that, although all entities have to capitalise borrowing costs on qualifying assets, there could be significant differences between the amounts capitalised and on which assets this would be applicable, depending on whether SFAS 34 or IAS 23 is applied. This may cast serious doubt on the usefulness of the IASB’s convergence project, specifically in regards to the capitalisation of borrowing costs.

In 1988, Means and Kazenski (1988:1) described SFAS 34 as a standard which lacks sufficient internal consistency to ensure that the application is verifiable and that the representation is faithful. SFAS 34 was never updated (only IAS 23 was revised with the convergence project), and therefore this criticism is still valid. The Financial Accounting Standards Board, or FASB (the standard-setting body of US GAAP) held the view that the interest forms part of the acquisition cost of a qualifying asset and thus forms part of the historical cost of the asset. The purpose of SFAS 34 was

therefore to capitalise interest which could have been theoretically avoided if the cost regarding the asset had been avoided. These principles remain the basis for SFAS 34 today, and therefore have also influenced the revision of IAS 23 so as to achieve convergence with SFAS 34.

Everingham and Watson (2006:9:1) are of the opinion that the capitalisation of borrowing costs can be theoretically supported by the facts that an asset can be viewed as a future economic benefit, or that it can give rise to future economic benefits. It is preferred that costs that will only lead to a benefit in the current period be accounted for as an expense, while costs that also retain benefits in future periods, have to be capitalised. In doing so, the matching of income and expenses can also be achieved.

According to the Framework of the International Accounting Standards Board (2009a:27) an asset takes the following definition: “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity”. The definition of an expense, also from the Framework (International Accounting Standards Board, 2009a:27), is the following: “decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants”.

Interest does not satisfy the definition of an asset, but it does satisfy the definition of an expense. Interest thus cannot be an asset. The cost of an asset includes the cost of bringing the asset to its current condition and location. Therefore, the inherent nature of the cost is not a determining factor in the capitalise-expense decision, but rather the reason for incurring the cost. Therefore, interest can be capitalised as part of the cost of an asset (Everingham & Watson, 2006:9:2). Supporting this reasoning, it is the opinion of the European Financial Reporting Advisory Group (2007) that the capitalisation of borrowing costs is consistent with the Framework. Considering that the capitalisation or non-capitalisation of borrowing costs, in their opinion, only influences the measurement of an asset (it deals with the cost of the asset), the definition of historic cost is relevant. The latter is the amount paid in cash and cash equivalents, or the fair value of the consideration paid, thus reflecting all costs incurred to prepare the asset for its intended use or sale. It is also their opinion that, seeing that all entities now follow the same approach, there will be greater consistency.

In contrast to the above claims, a number of arguments against the revision of IAS 23 were made by some members of the IASB, which include the following:

- The IASB did not investigate, in sufficient detail, the merits of both options (capitalisation or income statement approach) independently of each other.
- The change does not benefit the users because:
  - i. It only addresses one difference between IAS 23 and SFAS 34.
  - ii. The capital structure of an entity can influence the cost of an asset and therefore comparability is not improved.
  - iii. Credit analysts write back capitalised borrowing costs when cover ratios are calculated.
- The costs associated with the implementation of the capitalisation model may be significant.

The elimination of the incorrect alternative could lead to more comparable, but less useful information according to the European Financial Reporting Advisory Group (2007). They also acknowledged that, because of the revised IAS 23, entities who choose to reconcile IFRS statements to US GAAP statements will need to keep two sets of capitalisation records. Ms O'Malley, a member of the IASB, raised the same concern and described the change as unfair and unhelpful, adding that she would only vote in favour of the revision of IAS 23 if the effective date of the revised standard was set far enough into the future (International Accounting Standards Board, 2008:4). Another weakness pointed out by the European Financial Reporting Advisory Group (2007) was the uncertainty with regards to the exact structure of refinancing of qualifying assets and the question with respect to how borrowing costs should be allocated to qualifying assets in such circumstances.

There are still further arguments against the capitalisation approach. Selling (2007:1) is of the opinion that the acquisition of an asset is preceded by two decisions, being (1) the choice with regards to which assets to acquire (capital budget) and (2) how the asset would be paid for (capital structure). Interest is therefore a financing cost which is separate from the cost of acquisition and therefore, under these circumstances, it is illogical to capitalise interest. Selling (2007:1) even ventures to say that the capitalisation of borrowing costs was designed to smooth the earnings of large industrial companies and to undo the attempts of analysts to separately measure operating and financing expenses.

In spite of all the debates in favour of and against the capitalisation of borrowing costs, the fact remains that the standard has been revised and that all stakeholders will have to come to terms with the capitalisation approach. The question that now arises is how many companies there are, specifically in South Africa, that previously did not capitalise borrowing costs, and what the

practical implications are that may arise from the mandatory capitalisation of borrowing costs. Furthermore, there is also the major question which will almost certainly lead to many debates in the foreseeable future, namely what the cost of adherence to the new requirements will be, and whether this will justify the benefits obtained from the revision of IAS 23.

It may also be necessary to pay attention to the more technical matters of the revised standard, with which various entities may face problems as well as technical uncertainties in the establishment of principles and practices that are exercisable and that are in accordance with the requirements of the revised standard. A concern raised by Enslin (2008:22) is that most accountants who are currently in practice have become unfamiliar with the standard and the application thereof. He is also of the opinion that the theory of the standard has remained mostly untested in practice, with no generally accepted practices for the grey areas that are brought about by the practical application of the standard.

The problem statement of this research study, which can therefore be formulated from the above, is twofold:

- The mandatory capitalisation of borrowing costs, which is a fairly new requirement of the revised IAS 23, can lead to legions of **practical** problems for entities that did not previously choose capitalisation of borrowing costs as their accounting policy. Among others, these problems may include a lack of information, the cost relating to the production of the information and the usefulness of the capitalisation of borrowing costs.
- Because the theory of the standard remained relatively untested in practice, there may be various ‘grey’ areas and **technical** uncertainties in the revised standard, which entities in practice may find challenging to apply and which could lead to the production of inaccurate accounting information.

### **3. Research questions, objectives and goals**

The following research questions are formulated from the problem statement:

- What are the **practical implications** regarding the capitalisation of borrowing costs with which entities in practice are confronted?
- What are the **technical uncertainties** regarding the requirements in the revised IAS 23 with regards to the capitalisation of borrowing costs, and how should these technical uncertainties be interpreted?

The following objectives are derived from these research questions:

### 3.1. Primary objective

To identify practical and technical difficulties with the application of the revised IAS 23 (borrowing costs) and to make relevant suggestions to solve the problems identified.

### 3.2. Secondary goals

The goals of the study were:

- To determine whether accountants in practice perceive the mandatory capitalisation of borrowing costs as a **costly** exercise.
- To determine whether accountants in practice find the capitalisation of borrowing costs to be **difficult** to apply.
- To assess the **attitude** of accountants in practice towards the now mandatory capitalisation of borrowing costs.
- To evaluate the opinions of accountants in practice regarding certain aspects of the **accuracy and usefulness** of the capitalisation of borrowing costs, including inconsistencies between the revised IAS 23 and the corresponding US GAAP standard.
- To identify any possible **correlations** between accountants' opinions on cost effectiveness, difficulty, attitude and accuracy regarding the capitalisation of borrowing costs.
- To **compare** the opinions of different demographical groups of accountants in practice on cost effectiveness, difficulty, attitude and accuracy of the capitalisation of borrowing costs.
- To gain the opinions of South African accounting academics relating to the **technical uncertainties** with the application of the requirements of the revised IAS 23.
- To suggest the most appropriate accounting treatment of the technical uncertainties identified.

## 4. Basic hypothesis

A variety of practical and technical difficulties exist with the capitalisation of borrowing costs and the removal of the income statement approach may lead to the application of non-cost effective accounting.

## 5. Research method

The method of investigation which was used for the research follows:

## **5.1. Literature study**

A review of extant literature was conducted in order to analyse the arguments behind the capitalisation of borrowing costs, to identify the technical uncertainties within the standard which could cause problems in practice and also to identify possible practical problems regarding the application of the standard. Furthermore, a review of the results of recent South African and international research studies in the area of IFRS was conducted to provide a basis for the current research study.

## **5.2. Empirical research**

Except for the literature study, an empirical study was also undertaken in two parts as described below. The two parts form the basis of chapters two and three respectively.

### **Part 1**

A cross-sectional survey research design was employed (Trochim & Donnelly 2006:6). A questionnaire was designed based on the principles identified during the literature review. The questionnaire consisted of 11 demographical questions and 40 questions aimed at gathering the opinions of accountants on various practical issues relating to the application of the revised IAS 23. Each of these 40 questions required answers on a 4 point Likert scale where 1 indicated a strong disagreement and 4 a strong agreement with each question. The questions addressed the cost implications of accounting for borrowing costs under the revised IAS 23, the difficulty in applying the revised standard in practice, the attitude of practitioners concerning the revision of IAS 23, US GAAP complications and various matters regarding the accuracy and usefulness of some aspects of the revised IAS 23.

Validity and completeness of the subject matter of the questionnaire was ensured by developing questions for each different dimension identified during the literature review and ensuring that the questions relate to the affairs identified in the literature. The content validity of the questionnaire was ensured by the review of the questionnaire by various knowledgeable subject experts in the accountancy field, as well as by a qualified statistician.

A convenience sample (Trochim & Donnelly 2006:49) of 40 participants was drawn from a population consisting of all South African companies that were listed on the Johannesburg Securities Exchange (JSE) at the time. All potential participants in the sample were contacted telephonically to explain the purpose of the research study and to request their participation. The questionnaire was then distributed to all participants via e-mail. Ultimately, 36 responses were

obtained, representing a wide array of business sectors in the South African market. The individual who represented each participating company had at least the job title of “accountant”. The data obtained from the questionnaires was imported into the statistical software package SPSS (SPSS, 2008), where it was processed into functional information in order to describe the results obtained from the data.

## **Part 2**

The research design took the form of an empirical survey. The questionnaire consisted of five demographical questions and 15 questions aimed at gathering the opinions of Financial Accounting academics on various technical issues found within the revised IAS 23. Each of these 15 multiple-choice type questions required that an opinion be selected as to the correct answer for a given technical problem. An option was also made available in circumstances where a participant may have felt that none of the given options were correct. Participants were also encouraged to contribute qualitative comments above and beyond the standard options that were available.

The target population consisted of the Financial Accounting academics from all the universities in South Africa that are accredited by the South African Institute of Chartered Accountants to offer a chartered accountancy programme. An e-mail was sent to each lecturer identified together with the questionnaire attached. Participants completed the questionnaire and added relevant comments, after which it was returned to the researcher.

A total of 24 respondents completed the questionnaire after regular follow-up correspondence with the non-respondents. Apart from these respondents, the questionnaire was also sent to the technical department of a specific South African branch of a global audit firm. An additional three respondents from this firm completed the questionnaire. As this department within the firm addresses, amongst others, the technical accounting uncertainties that auditors encounter on a daily basis, and owing to the fact that this firm offers academic training for students in the process of completing their Honours degrees / Certificate in the Theory of Accountancy (similar to training provided by universities), the technical knowledge that personnel within this department have, can be viewed as at least equal to that of Financial Accounting lecturers at universities. A total of 27 respondents therefore participated in this study, all of which are regarded as possessing similar technical knowledge of IAS 23 (arguably the greatest repository of technical Financial Accounting knowledge of IAS 23 in South Africa).

The answers to each questionnaire were captured in a spreadsheet and the percentage of each option chosen by the participants, relative to other options under the same question, was calculated. Based

on these percentages, the accounting treatment most favoured by the participating academics could be identified for each technical uncertainty. Descriptive statistics were therefore obtained from this data analysis procedure. The qualitative comments made by each academic were also especially valuable and these have been summarised and reported where relevant.

## **6. Chapter Layout**

The research has been concluded in an article-based dissertation and divided into the following four chapters:

### **Chapter 1: Purpose, scope and extent of the study**

The key objective of this chapter is to serve as an introduction to the study and to illustrate the actuality and relevance of the topic. Furthermore, the objectives, the problem statement and research questions, the overall research hypothesis, as well as the research method are set out.

### **Chapter 2: Capitalisation of Borrowing costs: Practical difficulties and cost versus benefit**

In this chapter (the first article) relevant literature is quoted to support the design of questions aimed at the identification of practical problems and cost considerations in respect of the capitalisation of borrowing costs in practice. The method of investigation of the empirical study is briefly outlined and motivated in this chapter. The results of the empirical study relating to the practical difficulties and the cost effectiveness of the capitalisation of borrowing costs are presented. Conclusions regarding the empirical study are drawn, after which the limitations of the study are mentioned.

### **Chapter 3: Capitalisation of Borrowing costs: An investigation into technical uncertainties in IAS 23**

In this chapter (second article), relevant literature is quoted to support the design of questions aimed at the identification of possible grey areas regarding the application of the technical requirements of the revised standard regarding borrowing costs (IAS 23). The method of investigation of the empirical study in this chapter is briefly outlined and motivated. The results of the empirical study relating to the best solutions for the uncertainties stemming from the application of the technical requirements of the standard are set out, based on the questionnaire given to the academics. Lastly, the conclusions based on the empirical study are drawn and the limitations of the study outlined.

## **Chapter 4: Summary, conclusion and recommendations**

In this chapter the study is summarised by reiterating the main results, conclusions are discussed and recommendations are made. Moreover, the answers to the research objectives that have been identified in chapter 1 are demonstrated. The overall limitations of the study are outlined and suggestions for future research are proposed.

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## ***Chapter 2 (Article 1)***

### ***Capitalisation of Borrowing costs: Practical difficulties and cost versus benefit***

**Title:** Capitalisation of Borrowing costs: Practical difficulties and cost versus benefit.

The reader is requested to take note of the following:

- This article has been submitted for publication to the following SA approved, peer-reviewed and Department of Education accredited academic journal as follows:

Van Staden, L., Van der Merwe, N. & Breytenbach, J.W. 2010.  
Capitalisation of Borrowing costs: Practical difficulties and cost versus  
benefit. Meditari, unpublished. (ISSN 1022-2529).

- The article was researched and written by the first author as the candidate. The second and third authors fulfilled a 'reviewer' function thereto as the study leader and statistics consultant. Estimated weightings of contribution are estimated to be as follows:

\* Van Staden, L. (85%)

\* Van der Merwe, N. (10%)

\* Breytenbach, J.W. (5%)

- Confirmation of receipt of the article from Meditari Accountancy Research has been received and is presented as part of **Annexure C.1** on page **96**. The article was written in line with the journal's submission guidelines, which are included as part of **Annexure D.1** on page **98**.

## **Abstract**

As part of the International Accounting Standards Board's convergence project (eliminating differences between US GAAP and IFRS), quite a few accounting standards have been scrutinised and have emerged with changes ranging from small tweaks to radical alterations. One such accounting standard is IAS 23 *Borrowing Costs*. For accounting periods beginning on or after 1 January 2009, the capitalisation of borrowing costs became mandatory for companies applying IFRS. The practical implications relating to the capitalisation of borrowing costs for companies that have not previously capitalised, may be far-reaching. The difficulty and cost implications of the revised standard might outweigh the benefits obtained therefrom. Based on a survey of accountants employed by a number of listed South African companies, this study revealed that accountants do experience the capitalisation approach of IAS 23 as being difficult to apply while also revealing a slightly negative attitude towards the change made to the standard. It was also found that participants believed that mandatory capitalisation of borrowing costs is slightly more costly than not and that the benefits obtained from the capitalisation of borrowing costs are not that noticeable in practice. From the study, there was also an indication that participants who had already capitalised borrowing costs in the past, felt less pessimistic about the cost implications of mandatory capitalisation compared to participants who had not done so. This could suggest that participants' views of the revised IAS 23 were influenced by a lack of experience with the capitalisation approach.

## **Keywords**

Borrowing costs

Capitalisation

Convergence

IAS 23

International Financial Reporting Standards (IFRS)

Qualifying assets

United States Generally Accepted Accounting Principles (US GAAP)

## **1. Introduction**

The capitalisation of borrowing costs has long been a debated topic. Until fairly recently, those who were opposed to capitalisation were free to choose not to capitalise borrowing costs. However, effective for financial reporting periods beginning on or after 1 January 2009, this choice has been eliminated; consequently entities that apply International Financial Reporting Standards (IFRS) are now obliged to capitalise borrowing costs incurred on so-called “qualifying assets”, whether they agree with this accounting treatment or not (Enslin 2008:22; International Accounting Standards Board 2009a:1429). Because the capitalisation of borrowing costs influences the carrying amount of an asset, as well as the depreciation and interest charge in profit or loss and earnings per share figures, the issue of capitalisation of borrowing costs may be worth exploring.

According to the latest version of International Accounting Standard (IAS) 23, borrowing costs incurred on the financing of qualifying assets have to be capitalised against the cost of the asset. Such qualifying assets are those that necessarily take a substantial period of time to get ready for their intended use or sale (International Accounting Standards Board 2009a:1428). Gornik-Tomaszewski and Showerman (2006) explained that the main reason for this change was as a result of the ongoing International Accounting Standards Board’s (IASB’s) Short-term Convergence Project, of which the main goal is the reduction of differences between IFRS and the United States Generally Accepted Accounting Principles (US GAAP). The IASB’s argument is that the application of only one method, instead of a choice between two methods, will improve the comparability of financial statements.

However, Williams (2007:21) and the CFA Institute (2006) noted that the need for comparability should not be confused with mere uniformity. The European Financial Reporting Advisory Group (2007) mentioned that the elimination of the incorrect alternative in the accounting for borrowing costs could lead to more comparable, but less useful, information. Another concern raised by a member of the European Financial Reporting Advisory Group (2007) is the uncertainty regarding

the exact structure of the refinancing of a qualifying asset, which could result in questionable methods of apportioning borrowing costs to an asset.

Entities that did not capitalise borrowing costs in the past might experience a variety of challenges with the implementation of the revised IAS 23 which now requires mandatory capitalisation. According to a survey of the 2005 IFRS financial statements of 65 major companies performed by Ernst & Young, it would also seem that companies who previously chose not to capitalise borrowing costs are in the majority (Ernst & Young 2006) and that therefore very little attention was paid to the practical application of the capitalisation of borrowing costs in the past (Enslin 2008:22). In addition, Nestlé S.A. (2006) made the statement that IAS 23 does not properly address the practical matters related to the capitalisation of borrowing costs, especially in multi-national groups.

Maijoor (2010) is of the opinion that academic research must play an active role in research conducted with regards to the costs and benefits of changes in financial reporting standards. The main purpose of this article is to determine whether the change in IAS 23 towards mandatory capitalisation of borrowing costs does cause significant practical difficulties for companies in South Africa, as well as to establish the nature and extent of these problems.

More specifically, the study aims to achieve the following specific research objectives:

- To determine whether accountants in practice perceive the mandatory capitalisation of borrowing costs as a **costly** exercise.
- To determine whether accountants in practice find the capitalisation of borrowing costs to be **difficult** to apply.
- To assess the **attitude** of accountants in practice towards the now mandatory capitalisation of borrowing costs.

- To evaluate the opinions of accountants in practice regarding certain aspects of the **accuracy and usefulness** of the capitalisation of borrowing costs, including inconsistencies between the revised IAS 23 and the corresponding US GAAP standard.
- To identify any possible **correlations** between accountants' opinions on cost effectiveness, difficulty, attitude and accuracy regarding the capitalisation of borrowing costs.
- To **compare** the opinions of different demographic groups of accountants in practice regarding the cost effectiveness, difficulty, attitude and accuracy of the capitalisation of borrowing costs.

Based on the above research objectives, the hypothesis is that a variety of practical difficulties exist with regards to the capitalisation of borrowing costs which may possibly lead to the application of non-cost effective and/or inaccurate accounting.

The rest of the article is structured as follows: Firstly, the extant literature relevant to borrowing costs is reviewed; thereafter, the research methodology is presented and data analysis techniques are discussed; finally, the results are discussed and recommendations are made together with suggestions regarding directions for further research.

## **2. Literature review**

South African Generally Accepted Accounting Practice (SA GAAP) was traditionally used as a guideline for the preparation of financial statements in South Africa. In 1993 it was decided to eliminate differences between SA GAAP and IFRS, which includes International Accounting Standards (IAS) (Everingham, Kleynhans & Posthumus 2007:2-3). Thus, the South African standards closely resemble IFRS today (Vorster, Koornhof, Oberholster, Koppeschaar, Coetzee, Janse van Rensburg, Binnekade, Leith, Hattingh & De Klerk 2009:1-2), meaning that SA GAAP is really just a replica of IFRS.

The previous version of the standard on Borrowing Costs (IAS 23) is described by Enslin (2008:22) as a standard that had not been accorded much attention by students during their time of study. The

reason for this is probably that the capitalisation of borrowing costs was only a permitted alternative according to the previous standard, and that the so-called “income statement approach” (which is more elementary) was the norm. In terms of the income statement approach, all borrowing costs were expensed in profit or loss.

As mentioned previously, the definition of borrowing costs according to IAS 23 refers to: “interest and other costs an entity incurs in relation to the borrowing of funds” (International Accounting Standards Board 2009a:1428). According to the International Accounting Standards Board (2009a:1428), these costs could include interest, finance costs on finance leases and a portion of exchange rate differences.

Considering that entities previously had the choice of either capitalising borrowing costs or recognising them directly in profit or loss (the income statement approach), little attention was paid to the capitalisation of borrowing costs in practice (Enslin 2008:22). This is also evident from the lack of literature on the practical implications of accounting for borrowing costs, specifically. This study aims to contribute towards filling this research gap.

## **2.1. Accounting: the cost versus benefit debate**

One of the foundational premises of accounting is that the cost of producing financial information should be reasonable in relation to the benefit obtained from such information (International Accounting Standards Board, 2009c). One driver of such costs may be the need for systems and/or technology changes resulting from accounting policy changes. Past research has shown that these costs can be very extensive (DeFelice 2010; Morgant 2008). A recent study in New Zealand also proved that audit fee increases could be reliably associated with the transition to and adoption of IFRS (Griffin, Lont & Sun 2009). Training requirements are also intensified due to accounting changes (Carmona & Trombetta 2008). When these matters are considered in relation to Chua and Taylor’s (2008) findings that support for IFRS could be more politically than economically motivated, coupled with Jeanjean and Stolowy’s (2008) findings that earnings management did not

decline after the adoption of IFRS in Australia, France and the UK, significant doubt may arise regarding the cost effectiveness of many IFRS accounting principles.

More specifically in respect of borrowing costs, a number of arguments were raised against the revision of IAS 23 by some members of the IASB, one of which was that the cost relating to the implementation of the capitalisation model may be significant (International Accounting Standards Board 2009:1438). For small entities, it is especially complex, costly and time consuming to capitalise borrowing costs (Pervez 2006). Grant Thornton International (2006) concluded that the mandatory capitalisation of borrowing costs will increase cost and complexities for some preparers and the continuous documentation would be labour and cost intensive (Volkswagen AG 2006; DIAGEO 2006). An example of such costs would be the new systems that need to be developed and maintained for the purposes of determining the correct amount to be capitalised (BDO 2006; UNICE 2006).

## **2.2. The revised IAS 23: level of difficulty**

According to McCarthy (2004), accounting principles are increasingly becoming more complex, and quite often this is viewed as unnecessary and not conducive to reliable accounting. Over and above the possible cost implications, the revised IAS 23 may therefore be difficult to apply and various interpretations of the requirements of the standard may cause inconsistent application of these requirements.

One such complexity can be demonstrated by the South African Institute of Chartered Accountants' (2006) request to the IASB for specific guidance on whether an intangible asset will fall within the scope of a qualifying asset as defined. More specifically, the Institute wanted to know whether the requirements of the standard on intangible assets (IAS 38) would influence IAS 23, particularly with regard to the development phase of internally generated intangible assets.

According to PricewaterhouseCoopers (2006), IAS 23 is also silent about whether the effective portion of a derivative instrument that qualifies as a hedging instrument in a fair value hedge or cash flow hedge should form part of capitalised borrowing costs. This firm also mentioned that it would be helpful if further guidance could be provided as to which borrowing costs should be included in determining the weighted average capitalisation rate.

Judgements are an integral part of accounting in general (Schmutte & Duncan 2009:32; Psaros & Trotman 2004). One such area in IAS 23 that specifically requires judgement is the term “substantial period of time” (as encountered in the definition of “qualifying asset”), which is not defined in IAS 23 (Enslin 2008:22). This is just one example of the many technical intricacies in IAS 23 which add to the difficulty in applying the capitalisation approach.

### **2.3. Accountants’ attitudes towards change**

Tsakumis (2007) and Sacho and Oberholster (2008:130) stated that accountants are expected to apply accounting standards coherent with their cultural values and attitudes. They found that financial reporting decisions differ between countries, because of the differences in the cultural values of accountants applying those rules, especially those rules that require the application of judgement. Sacho and Oberholster (2008:130) indicated that forcing countries to adopt accounting standards by applying the same template contains flaws and may result in inconsistent application. Mir and Rahaman (2005:816) warned that the adoption of IFRS by developing countries will be filled with pitfalls, leading to increased confusion and conflict amongst practitioners. This statement might well be true for the revised version of IAS 23.

According to Raghavan (2009:14), the Financial Accounting Standards Board (FASB), which is the USA accounting standard-setter, and the IASB have been working steadily towards convergence and harmonisation of US GAAP with IFRS since 2002. However, the convergence efforts have experienced slower than anticipated progress, largely due to the reluctance of accountants and auditors to move away from the safety of rules-based standards and the differences in styles and

wording of standards caused by cultural diversity (Raghavan 2009:14). According to Williams (2007), the idea of capitalising interest cost met a reaction that ranged from scepticism to hostility. This may indicate that the attitudes of professional accountants and auditors are negative or averse to changes in accounting standards in general, and could therefore be a motivator for objections against the mandatory capitalisation of borrowing costs.

#### **2.4. Accuracy and usefulness of the change in IAS 23**

The application of IFRS does not necessarily mean that accurate and useful financial information is produced in every respect. Based on a study using a sample of German companies, Paananen and Henghsiu (2009) concluded that accounting quality has not improved after the adoption of IFRS, but in fact deteriorated. In a survey of 498 preparers and auditors of accounts by Beattie, Fearnley and Hines (2008), the participants believed that IFRS had undermined UK financial reporting integrity prior to the “credit crunch”, thus further supporting this conclusion.

In respect of the revised IAS 23, some experts question whether the specific prescribed approach would lead to the most accurate figure for capitalised borrowing costs, and whether the approach of capitalisation in itself (as opposed to the income statement approach) is useful and would provide an accurate representation of the economic substance of the transaction. According to McClelland (2006) investors prefer that costs such as interest should be expensed immediately. Capitalisation of these costs conceals poor performance of a company. McGeachin and Manso (2006) also pointed out that the IASB considered the use of an economic interest cost approach, based on a market risk-adjusted rate (which would reflect the current market assessment of the time value of money and the risk specific to the asset) to capitalise borrowing costs, instead of the current specific or weighted average rates that can be used. This indicates that the prescriptions in IAS 23 are not the only alternatives available, and therefore perhaps not the most accurate.

As stated previously, the main reason for the revision of IAS 23 is the IASB’s Short-term Convergence Project whereby differences between IFRS and US GAAP are being reduced (Gornik-

Tomaszewski 2003:39). SFAS 34 is the US GAAP standard which addresses the treatment of borrowing costs. Subsequent to the convergence, there were still some differences between SFAS 34 and IAS 23, including dissimilar definitions for qualifying assets and borrowing costs, a difference in the treatment of investment income on temporary unutilised funds and a different degree of judgement to be applied in determining a suitable capitalisation rate (International Accounting Standards Board 2007:1-2). The conclusion one might arrive at is that, although all entities now have to capitalise borrowing costs on qualifying assets, there could still be significant differences between the amounts that have to be capitalised and the type of assets this practice applies to, depending on whether SFAS 34 or IAS 23 are used. This may cast significant doubt on the usefulness of the IASB's convergence project. In fact, various research studies on IFRS–US GAAP reconciliations found that a significant gap existed between IFRS and US GAAP measures of income, thus supporting critics' claims that standard-setters have more work to do to achieve a significant degree of convergence (Gray, Linthicum & Street 2009; Henry, Lin & Yang 2009).

Another argument that was raised against the revision of IAS 23 by some members of the IASB (International Accounting Standards Board 2009a:1438) was that the change may not be beneficial for its users because it only addresses one difference between IAS 23 and SFAS 34. Furthermore, the capital structure of an entity may influence the cost of an asset and therefore comparability is not improved. Credit analysts also write back capitalised borrowing cost when cover ratios are calculated. This fact is also mentioned by Selling (2007) who reveals that the capitalisation approach was nefariously designed to smooth the earnings of the largest industrial companies. Yet another argument advanced was that the capitalisation of borrowing costs is a measurement issue and measurement will be addressed in the development of the new IFRS Conceptual Framework; therefore the benefits of a revised IAS 23 might only last until the publication of an amended Conceptual Framework (International Accounting Standards Board 2006).

Sealy-Fisher (2008:46) explained that ED 35, a proposed revision to International Public Sector Accounting Standard (IPSAS) 5 on Borrowing Costs, was issued for comment on 3 September 2008 by the International Public Sector Accounting Standards Board (IPSASB). ED 35 proposed that public sector entities recognise borrowing-related expenses, such as interest or loan origination fees, in profit or loss during the period in which they are incurred. However, ED 35 further proposed that where entities borrow funds specifically to acquire, construct or produce a qualifying asset, the entity has the option to capitalise those costs as part of the cost of that asset. These proposals constitute a departure from both IPSAS 5 and IAS 23 *Borrowing Costs* and have evolved from the IPSASB's consideration that, in many circumstances, the capitalisation of borrowing costs as part of the cost of an asset is not appropriate for public sector entities (Babiak 2008:71).

The standard on IFRS for Small and Medium-sized Entities (International Accounting Standards Board 2009b:151) requires that borrowing costs be recognised as an expense in profit or loss, in the period during which they are incurred. This raises certain questions regarding the logic behind the capitalisation of borrowing costs being mandatory for IFRS companies, but not for public sector companies and small and medium-sized entities. It is not expected that the differences between these various types of entities could be so vast that one accounting framework would require capitalisation, whereas two others require expensing. In South Africa for example, most private companies would qualify for the application of IFRS for SMEs (South African Institute of Chartered Accountants 2009:CC02/09-3) whereas many of them could be as large as public listed companies which do not qualify for the application of this accounting framework.

## **2.5. Concluding remarks**

All of the above literature suggests that various practical difficulties may be faced when actually applying the capitalisation approach in practice, including the cost effectiveness of such application, the difficulty in applying this revised standard, the attitude of accountants towards this change and a need for reconciliations between US GAAP and IFRS, to name but a few. Although it is no longer a

Securities Exchange Commission (SEC) requirement to prepare IFRS–US GAAP reconciliations, entities may still experience a need for voluntary reconciliations. As mentioned earlier, empirical peer-reviewed research on these issues specific to IAS 23 appears never to have been carried out, and certainly not in a South African context. Research into these practical challenges may cast some light on the extent of these problems, if any, and should provide a base for future research which could ultimately lead to the development of a more workable, yet accurate model that is the most useful for decision-making.

### **3. Methodology**

A review of relevant literature was conducted in order to identify possible practical obstacles which accountants may encounter regarding the application of the revised IAS 23, which now mandates capitalisation of borrowing cost relating to qualifying assets.

The research design employs the form of an empirical survey: therefore the study follows a largely quantitative methodological paradigm (Mouton 2001:152-153; Davies 2007:188; Lategan, Hay, Holtzhausen, Truscott & Vermeulen 2005:19-25). A cross-sectional survey design was used (Trochim & Donnelly 2006:6). A questionnaire was designed based on the principles identified during the literature review. The questionnaire consisted of 11 demographic questions and 40 questions aimed at gathering the opinions of accountants on various practical issues relating to the application of the revised IAS 23. Each of these 40 questions required answers on a 4 point Likert scale where 1 indicated a strong disagreement and 4 a strong agreement with each question. The first group of questions focussed on the **cost** implications of converting to and accounting for borrowing costs under the revised IAS 23, the second group of questions focussed on the **difficulty** of applying the revised standard in practice and the third group on the **attitude** of practitioners concerning the revision of IAS 23. In addition, a group of questions with regards to US GAAP complications, as well as some specific questions on various matters regarding the accuracy and usefulness of some aspects of the revised IAS 23, were included.

The validity and completeness of the subject matter of the questionnaire was ensured by developing questions for each different dimension identified during the literature review and making sure that the questions related to the affairs identified in the literature. The content validity of the questionnaire was guaranteed by a review of the questionnaire by various knowledgeable subject experts in the accountancy field, as well as by a qualified statistician.

A convenience sample (Trochim & Donnelly 2006:49) of 40 participants was drawn from a population consisting of all South African companies that were listed on the Johannesburg Securities Exchange (JSE) at the time. All potential participants in the sample were contacted telephonically in order to explain the purpose of the research study and to request their participation, after which the questionnaire was distributed to all participants via e-mail. Ultimately, 36 responses were obtained, representing a wide array of business sectors in the South African market. The main reason for using a convenience sample is the difficulty in collecting responses from the accountants of large listed companies, mainly due to the time constraints these individuals experience in completing research surveys and a reluctance to make sensitive company information available to others.

The individual who represented each participating company had at least the job title of “accountant”. All questionnaires received back were captured in a spreadsheet. The data was then imported into the statistical software package SPSS (SPSS, 2008), where it was processed into functional information in order to describe the results obtained from the data.

Since the sample was a convenience sample, the extrapolation of results to the entire population of listed companies in South Africa was not attempted; however, meaningful results were obtained from the specific sample which go a long way to better understanding accountants’ views on the various practical concerns regarding the revised IAS 23; these results could also be used as a base for further research.

## **4. Results**

### **4.1. Demographic placement of participants**

The following demographic information was obtained by analysing the data from the questionnaire so as to better understand the sample of participants.

Eighty-nine percent (89%) of participants were members of a professional accountancy body. Seventy-two percent (72%) were members of the South African Institute of Chartered Accountants (SAICA), making this the most fully represented accountancy body in the sample of participants. Thirty-one percent (31%) of participants had been members of an accountancy body for more than ten years while 33% had been members for five years or less. Nineteen percent (19%) had been members for more than five but less than ten years.

Participants who had been employed by the same company for ten years or more represented 14% of all participants, whereas 11% had been employed for more than five years but less than ten years. The remainder (75%) had been employed by the same company for less than five years.

Of all the companies represented by the participants, 64% possessed qualifying assets as defined by IAS 23 and 53% of the total participants already had the policy of capitalising borrowing costs even before the revised IAS 23 made this compulsory. Before IAS 23 was revised, only 14% of participating companies chose not to capitalise borrowing costs. The rest had either already capitalised borrowing costs, or did not have any qualifying assets. Thus it is apparent that there might be more companies in South Africa that possess qualifying assets than might have been expected; furthermore, perhaps more companies chose to capitalise borrowing costs before the revision of IAS 23 than might have initially been thought (although these results cannot be generalised to the total population).

Twenty-five percent (25%) of participants indicated that, even though the revised IAS 23 requirements were not relevant to them at the time that they completed the questionnaire, they

might become relevant in the foreseeable future. Therefore, the mandatory capitalisation of borrowing costs might significantly affect these participants in the near future.

## 4.2. Descriptive statistics of some individual questions

The table below presents descriptive statistics for most (not all) of the questions in the questionnaire. It is considered that these questions convey the most noteworthy results of the study; therefore only the results for these questions are individually reported.

**Table 1: Descriptive statistics of some individual questions in the questionnaire**

	<b>N</b>	<b>Mean</b>	<b>Std Deviation</b>
Practitioners need training in capitalisation leading to increased training expenses.	36	2.72	.51
A new information system necessitated by the mandatory capitalisation of borrowing costs will lead to costly increased accounting work.	36	2.67	.68
Mandatory capitalisation requires a modified internal control system, leading to more fees.	36	2.64	.59
Mandatory capitalisation leads to increased accounting expenses.	36	2.61	.49
Capitalisation leads to complicated accounting for construction contracts.	36	2.81	.75
Requirements of mandatory capitalisation are not easy to apply.	36	2.81	.71
Capitalisation increases the difficulty of accounting for foreign currency loans used to finance construction.	36	2.89	.67
Training is necessary due to the complexity of capitalisation.	36	2.75	.50
Capitalisation complicates the accounting of internally generated intangible assets.	36	2.89	.58
Capitalisation combined with intra-group financing complicates the consolidation process.	36	3.28	.74
Capitalisation leads to a challenging measurement process.	36	2.78	.54
Allocation of capitalised borrowing cost to separately identifiable components is difficult.	36	2.67	.72
SAICA and the APB should have done more to prevent capitalisation becoming mandatory.	35	2.29	.57
There are other standards with a greater need to be updated.	36	3.03	.70
The previous version of IAS 23 worked well and there was no need for the irritable change.	36	2.92	.65
A subsidiary (using IFRS) of a US GAAP company would have to keep 2 sets of records; therefore the revised IAS 23 does not promote comparability.	34	2.71	.76
Differences between US GAAP and IFRS cause confusion and increase the difficulty of the calculation.	32	2.75	.62
The burden of keeping 2 sets of records (where IFRS and US GAAP are reconciled) adds to the complexity of IAS 23.	36	3.31	.71
For companies reconciling to US GAAP, the revised IAS 23 leads to additional accounting work and/or audit fees.	33	2.91	.68
The use of an economic interest rate would result in a more accurate measure of the amount of borrowing costs being capitalised compared to IAS 23	36	2.19	.67
Because only partial convergence exists between IFRS and US GAAP, the change is only temporary and therefore the revision of IAS 23 is only	34	2.59	.61

	N	Mean	Std Deviation
an annoyance.			
The IASB did not adequately consider the cost implications.	36	2.89	.62
The benefits obtained from capitalisation are not noticeable in practice.	36	2.81	.58
Mandatory capitalisation leads to uniformity but not comparability.	36	2.78	.72
Credit analysts writing back capitalised borrowing costs show that capitalisation is not very useful.	36	2.67	.68
Mandatory capitalisation can lead to an insolvent company appearing solvent.	36	2.67	.54
Profit will be higher and thus measured less truthfully.	36	2.39	.69
Users of financial statements prefer inclusion of capitalised borrowing costs in earnings per share.	35	2.37	.81
Capitalisation of borrowing costs leads to less accurate accounting.	36	2.28	.78

The above statistics are discussed under relevant headings below. It should be noted that a mean of 2.5 represents the middle of the 4 point scale that was used, i.e. it is exactly in the middle of 2 (“disagree”) and 3 (“agree”).

#### 4.2.1. Cost

With a mean of 2.72, training seems to be the main cause of increased costs, followed closely by the cost of a new information system leading to increased accounting work ( $m = 2.67$ ). A modified internal control system ( $m = 2.64$ ) and accounting expenses ( $m = 2.61$ ) also played a role in increased costs of adopting the revised IAS 23.

#### 4.2.2. Difficulty

With a mean of 3.28, the factor which proved most difficult was capitalisation combined with intra-group financing and the consolidation process thereof. Internally generated intangible assets and foreign currency loans (both with  $m = 2.89$ ) were also considered to be fairly difficult. Participants tended to agree that requirements for capitalisation are not easy to apply ( $m = 2.81$ ) and that training is necessary ( $m = 2.75$ ) owing to the complexity of these requirements.

Although the measurement process as a whole was viewed as fairly challenging ( $m = 2.78$ ), the allocation of borrowing costs to separately identifiable components of qualifying assets was regarded as slightly less difficult ( $m = 2.67$ ).

### **4.2.3. Attitude**

Participants did not really feel that SAICA should have done more to prevent mandatory capitalisation ( $m = 2.29$ ). This is understandable as SAICA would probably have exercised only limited influence over the IASB's decision. However, the participants mostly agreed that other standards had a greater need for updating ( $m = 3.03$ ) and that there was no need for a change to the previous version of IAS 23 ( $m = 2.92$ ).

### **4.2.4. US GAAP complications**

Participants were of the opinion that the differences that still exist between US GAAP and IFRS do not promote comparability ( $m = 2.71$ ), cause confusion ( $m = 2.75$ ), are burdensome and complex ( $m = 3.31$ ) and lead to additional accounting work ( $m = 2.91$ ).

### **4.2.5. Accuracy of capitalisation rate**

It would appear that the use of an economic interest rate (applying a current market risk-adjusted rate of return for capitalisation), according to the participants, would not necessarily increase the accuracy of the amount of borrowing costs being capitalised ( $m = 2.19$ ), compared to the current approach prescribed by IAS 23 .

### **4.2.6. Accuracy and usefulness of the capitalisation approach**

Participants felt that the IASB did not adequately consider the cost implications in their decision to change IAS 23 ( $m = 2.89$ ). They also felt that the benefits obtained from the capitalisation of borrowing costs are not noticeable in practice ( $m = 2.81$ ) and that the mandatory capitalisation may lead to uniformity, but not comparability, of financial statements ( $m = 2.78$ ). The motivation of the IASB for making the change to IAS 23 was to enhance comparability. It would seem that the participants felt that this aim would not be achieved. Although to a lesser degree, it also appears that the participants questioned the usefulness of capitalising borrowing costs, seeing that credit analysts write back the capitalised cost anyway ( $m = 2.67$ ). The majority of them also felt that the mandatory capitalisation might lead to an insolvent company appearing solvent ( $m = 2.67$ ).

The majority of participants did not agree that the higher profit due to capitalised borrowing costs would be less accurately measured ( $m = 2.39$ ) and, consequently, the increase in earnings per share as a result of capitalising borrowing costs also appears not to have been a major concern in the achievement of accurate accounting ( $m = 2.37$ ). Overall, participants tended to disagree that the capitalisation of borrowing costs leads to less accurate accounting ( $m = 2.28$ ).

### **4.3. Reduction of data into different components**

In order to reduce the large number of variables in the questionnaire into a more manageable number, a factor analysis, in the form of a principal components analysis (PCA), was performed on the data by using SPSS (SPSS, 2008) to identify different constructs (components). In this particular research study on the capitalisation of borrowing costs, a confirmatory factor analysis was performed on a component by component basis (e.g. all questions relating to cost implications were subjected to a factor analysis and all questions relating to accountants' attitude were subjected to a different factor analysis, etc.). Inspection of each correlation matrix revealed the presence of many coefficients of .3 and above, indicating that the data was suitable for PCA (Pallant 2007). Furthermore, all Kaiser-Meyer-Olkin Measures of Sampling Adequacy (MSA) exceeded the recommended value of .5 (Hair, Anderson, Tatham & Black 1998; Kaiser 1970; Kaiser 1974), supporting the factorability of the respective correlation matrices. The respective factor analyses explained between 62% and 82% of the variance cumulatively. Catell's scree test (Catell 1966) supported the retention of only one component per group of questions in all instances. Although not all components completely satisfied Tabachnick and Fidell's (2007) suggested ratio of five cases per item, the Cronbach alpha coefficients obtained for all components met the requirement of .7 for a component to be considered reliable (Field 2005:668; DeVellis 2003; Pallant 2007:95).

Thirty-two of the 40 questions were reduced into five different components (see table 2 below) that reported the combined result of various questions within each of these components, but there were

also 8 unique questions regarding various aspects of the accuracy and usefulness of the revised IAS 23, which were reported separately (refer section 4.2), i.e. not as a combined component.

**Table 2: Results of factor analysis**

Component	MSA	Cronbach alpha
Cost (8 items)	.734	.810
Difficulty (8 items)	.789	.821
Attitude (9 items)	.831	.888
US GAAP complications (5 items)	.628	.810
Accuracy of capitalisation rate (2 items)	.500	.776

#### 4.4. Descriptive statistics of components

The means of all components were calculated as the average means of individual questions belonging to each component. Descriptive statistics for each component of the questionnaire are presented in the table below.

**Table 3: Descriptive statistics of components**

	N	Mean	Std Deviation
Cost	36	2.57	.379
Difficulty	36	2.86	.437
Attitude	36	2.57	.503
US GAAP complications	36	2.87	.536
Capitalisation rate	36	2.33	.598

The mean for **cost** is 2.57. Therefore it appears that the participants considered the mandatory capitalisation of borrowing costs to be slightly more costly rather than less. Furthermore, with a mean of 2.86, practitioners agreed that capitalisation of borrowing costs is fairly **difficult** to apply in practice. The **attitude** component explored the attitudes of practitioners towards the change made to IAS 23, being the mandatory capitalisation of borrowing costs on qualifying assets. The mean of 2.57, being approximately in the middle of “agree” and “disagree”, together with the standard deviation of .50, indicated that practitioners did not possess a particularly negative attitude towards the change, but that they were not particularly positive about the change either. However, it does appear that they held a slightly more negative than positive attitude towards the change. The **US GAAP complications** component aimed to establish whether the differences between IFRS and

US GAAP that still exist are burdensome, complex, lead to additional work and result in confusion with the accounting with regards to borrowing costs. With a mean of 2.87, this appeared to be the case based on the responses of participants. It also seems that the participants did not consider the IAS 23 **capitalisation rate** to be particularly inaccurate when calculating the borrowing cost to be capitalised ( $m = 2.33$ ).

#### 4.5. Correlations between components

Valuable information can be obtained by identifying the degree of correlation between the different components in the questionnaire. This could be employed to investigate the linear relationship between the different components in order to conclude whether or not the accountants' opinion with regards to one component is associated with their opinion regarding another. The relationships between all the different components in the questionnaire were investigated using Pearson's product-moment correlation coefficient (Field 2005: 129-130; Pallant 2007:126). Field (2005:111) and Pallant (2007:132) provide the following guidelines for interpreting the strength of correlation coefficients:

- Small effect:  $r = .10$
- Medium effect:  $r = .30$
- Large effect:  $r \geq .50$  (and also practically significant).

In some instances, **partial** correlation coefficients were also calculated between two specific components by controlling **all** other variables in the questionnaire.

The following correlations exerted a large effect:

- There was a strong, positive correlation between difficulty and cost,  $r = .756$ ,  $N = 36$ . This may suggest that the more difficult the calculation and application of capitalising borrowing costs is, the more costly it becomes. It is also worth noting that a **partial** strong positive correlation of  $r = .614$  existed between cost and difficulty, thus further supporting the conclusion reached since the partial correlation coefficient controlled for all other variables in the questionnaire.

- There was a strong, positive correlation between attitude and cost,  $r = .548$ ,  $N = 36$ . This might suggest that the more costly the application of IAS 23 is because of mandatory capitalisation, the more negative the participants felt towards capitalisation.
- There was a strong, positive correlation between attitude and difficulty,  $r = .689$ ,  $N = 36$ . This might suggest that the more difficult the application and calculation of borrowing costs, the more negative the participants felt towards capitalisation. It might however also possibly be true that participants experienced the capitalisation of borrowing cost as being difficult because they held a negative attitude towards it. It is also worth noting that a **partial** medium to large positive correlation of  $r = .469$  existed between attitude and difficulty, thus further supporting the conclusion reached.
- There was a strong, positive correlation between the accountants' attitude and their perceptions of the usefulness of capitalising borrowing costs seeing that these are written back by credit analysts in any case,  $r = .646$ ,  $N = 36$ . This might suggest that, because capitalised borrowing costs are written back and are therefore not perceived as being useful, a negative attitude towards capitalisation was fostered among the participants.

#### **4.6. Comparison of different demographic groups**

Useful information can be obtained by comparing the means between different demographic groups within the sample of this research study. Effect sizes ( $d$ ) were calculated in order to assess the practical significance of the findings. Steyn (2000) suggests that  $d$  should be calculated as the difference between the means divided by the maximum standard deviation of the two groups that are compared. Please note that sig. values (p values) are reported only for the sake of completeness, but that interpretations are based on effect sizes (practical significance) only, since a convenience sample was employed in this study and therefore inferential statistics were not used.

#### 4.6.1. Comparison by period of membership of an accountancy body

Participants were divided between those who had been members of their respective accountancy bodies for less than ten years and those who had been members for more than ten years. Cohen (1988) provides the following guidelines for the interpretation of the effect size  $d$ :

- Small effect:  $d = .2$
- Medium effect:  $d = .5$
- Large effect:  $d \geq .8$  (and also practically significant)

The results of the mean comparisons are as follows:

**Table 4: Mean comparisons by period of membership**

Component / individual question	Less than 10 years			More than 10 years			Sig. (2-tailed, if a random sample was assumed)	Effect size $d$
	N	Mean	Std. Deviation	N	Mean	Std. Deviation		
Cost	19	2.58	.34	11	2.75	.34	.200	.49
Difficulty	19	2.88	.48	11	3.00	.43	.447	.29
Attitude	19	2.46	.46	11	2.91	.49	.014*	.93 <sup>▲</sup>
US GAAP	19	2.75	.59	11	2.96	.31	.299	.34
Interest rate	19	2.34	.78	11	2.32	.46	.923	.03
IASB cost considerations	19	2.89	.57	11	3.00	.63	.642	.17
Accurate accounting	19	2.26	.65	11	2.27	1.01	.975	.01
No noticeable benefits	19	2.89	.57	11	2.91	.54	.946	.03
Less truthfully measured profit	19	2.32	.67	11	2.55	.82	.412	.28
Uniformity, not comparability	19	2.84	.50	11	2.73	1.01	.730	.11
Earnings per share accuracy	19	2.21	.71	11	2.36	.81	.594	.19
Usefulness due to write-backs	19	2.68	.75	11	2.82	.60	.618	.18
Company appearing solvent even if not	19	2.53	.51	11	2.91	.30	.016*	.75 <sup>▲</sup>

\* Significant at the 0.05 level in case of random sampling.

▲ Large effect (practically significant)

The following differences in means revealed noticeable effect sizes:

- The attitude of participants with more than ten years of experience ( $m = 2.91$ ) seems to have been more negative towards the now mandatory capitalisation of borrowing costs compared with that of participants reporting less than ten years of experience ( $m = 2.46$ ). This can be regarded as a large effect ( $d = .93$ ). It may indicate that mature accountants were more reluctant to accept changes in accounting standards than younger accountants.
- Participants with more than 10 years of experience ( $m = 2.91$ ) believed more strongly that the capitalisation of borrowing costs might lead to an insolvent company appearing solvent

compared to participants reporting less than ten years of experience ( $m = 2.53$ ). This is regarded as a large effect ( $d = .75$ ).

- One might have expected that more mature participants ( $m = 3.00$ ) would have felt more strongly that capitalisation of borrowing costs is difficult, compared to younger participants ( $m = 2.88$ ). But as can be noted from the above, the effect is quite small ( $d = .29$ ). This may afford an indication that participants who had been members of a professional body for more than ten years were still as technically competent (or at least they perceived themselves as such), because they did not find these revised accounting principles significantly more difficult than their peers with less experience.

#### 4.6.2. Comparison by presence of qualifying assets

A mean comparison was made between companies in the sample with qualifying assets and those without. The results are summarised below:

**Table 5: Mean comparisons by presence of qualifying assets**

Component / individual question	Qualifying assets			No qualifying assets			Sig. (2-tailed, if a random sample was assumed)	Effect size $d$
	N	Mean	Std. Deviation	N	Mean	Std. Deviation		
Cost	23	2.44	.37	13	2.80	.29	.003*	.96 <sup>▲</sup>
Difficulty	23	2.66	.41	13	3.20	.22	.000*	1.31 <sup>▲</sup>
Attitude	23	2.35	.38	13	2.95	.48	.000*	1.25 <sup>▲</sup>
US GAAP	23	2.75	.61	13	3.06	.29	.099	.50 <sup>△</sup>
Interest rate	23	2.28	.64	13	2.42	.53	.506	.22
IASB cost considerations	23	2.65	.65	13	3.00	.82	.168	.43
Accurate accounting	23	2.83	.58	13	3.00	.71	.429	.25
No noticeable benefits	23	2.17	.78	13	2.46	.78	.294	.37
Less truthfully measured profit	22	2.45	.86	13	2.23	.73	.436	.26
Uniformity, not comparability	23	2.74	.62	13	2.92	.49	.365	.30
Earnings per share accuracy	23	2.48	.67	13	3.00	.58	.020*	.78 <sup>▲</sup>
Usefulness due to write-backs	23	2.30	.64	13	2.54	.78	.334	.30
Company appearing solvent even if not	23	2.61	.58	13	2.77	.44	.358	.28

\* Significant at the 0.05 level in case of random sampling.

△ Medium effect

▲ Large effect (practically significant)

The mean of the cost component is 2.80 for participants without qualifying assets compared to 2.44 for participants with qualifying assets. The mean of the difficulty component for participants without qualifying assets was also much higher than for those with qualifying assets ( $m = 3.20$  vs.

$m = 2.66$ ). The means of the attitude component followed a similar trend ( $m = 2.95$  vs.  $m = 2.35$ ). These effects can be regarded as practically significant ( $d = .96$  for cost,  $d = 1.31$  for difficulty,  $d = 1.25$  for attitude). This might indicate that participants who possessed experience in the application of capitalisation tended to recognise that it is not so difficult or costly to apply, and therefore their attitude towards it was also less negative. It consequently appears that participants who had not physically dealt with capitalisation possessed a preconceived idea, which might not be entirely valid, with regards to capitalisation.

#### **4.6.3. Comparison by business sector**

Participants were divided into three different groups of similar business sectors, being (a) Energy and natural resources (including mining), (b) Manufacturing and production and (c) Retail and services. There were no large or medium effect sizes identified between any of the different business sectors. In other words, participants from different business sectors held similar opinions regarding cost and difficulty, and the sector they represented did not significantly influence their attitude towards capitalisation. This suggests that differences in business sectors did not materially influence the answers of participants.

## **5. Conclusion and recommendation**

In the light of the results of this study, it was found that participants believed that mandatory capitalisation of borrowing costs is more costly than not, and that training appears to be the main driver of these additional costs. Participants seemed to agree that the application of IAS 23 is fairly difficult especially when intra-group financing and consolidations are involved. Internally generated intangible assets and foreign currency loans also increase the level of difficulty when applying IAS 23. Participating accountants tended to possess a slightly more negative attitude towards the revised IAS 23, rather than a positive one. This slightly negative attitude could influence the opinions of practitioners into feeling that the revised IAS 23 is both costly and difficult. Also, the more difficult the application, the more costly it would be.

To a lesser degree the usefulness of capitalising borrowing costs appears to have been questioned, as credit analysts write back the capitalised costs anyway. From the viewpoint of the participants, the mandatory capitalisation may lead to uniformity, but not comparability of financial statements. Participants, however, did not significantly question the accuracy of the revised standard. According to them, the accuracy of the amount of borrowing costs being capitalised would not necessarily be increased with the use of an economic interest rate.

Participants who possessed experience with the application of capitalisation regarded the application of the revised IAS 23 to be less difficult or costly to apply compared to the opinions of their less experienced peers, and therefore their attitude towards the capitalisation approach was also less negative.

However, as the mandatory capitalisation of borrowing costs were perceived to be both costly (in various respects) and difficult, the overall conclusion that can be drawn is that the mandatory capitalisation of borrowing costs was regarded as something that is more negative than positive. This result could provide a base for further research to explore the matter further, which could ultimately be used as an input in the development of a revised IFRS standard in future. Other researchers are therefore encouraged to contribute towards research in this area and it is recommended that, based on the results of this study and possible future studies, standard-setting bodies revise the standard on borrowing costs to address practical challenges and inefficiencies.

## **6. Limitations and future research**

Limitations of the study include the fact that only 36 companies ultimately participated in this study. The sample was not selected randomly (it was a convenience sample) and therefore the results could not be extrapolated for the entire population.

Apart from expanding the research conducted in this study, further areas of study could include investigating the broader field of the IASB convergence projects. This could be implemented for

individual IASB projects or a collective study on the impact of these convergences and whether they exert the positive effect that is desired. Another possibility is investigating the differences between IFRS and US GAAP and the detailed impacts and effects that these differences exert on financial statements and decision-making. Researching the suggestions made by respondents in the letters of comment to the IASB might also prove beneficial. One such example was the suggestion that an economic interest rate should be used when calculating the amount of borrowing costs to be capitalised.

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## *Chapter 3 (Article 2)*

### *Capitalisation of Borrowing costs: An investigation into technical uncertainties in IAS 23*

**Title:** Capitalisation of Borrowing costs: An investigation into technical uncertainties in IAS 23.

The reader is requested to take note of the following:

- This article has been submitted for publication to the following SA approved, peer-reviewed and Department of Education accredited academic journal as follows:

Van Staden, L. & Van der Merwe, N. 2010. Capitalisation of Borrowing costs: An investigation into technical uncertainties in IAS 23. SAJAR, unpublished. (ISSN 1029-1954).

- The article was researched and written by the first author as the candidate. The second author fulfilled a ‘reviewer’ function thereto as the study leader. Estimated weightings of contribution is estimated to be as follows:

\* Van Staden, L. (90%)

\* Van der Merwe, N. (10%)

- Confirmation of receipt of the article from SAJAR has been received and is presented as part of **Annexure C.2** on page **97**. The article was written in line with the journal’s submission guidelines, which are included as part of **Annexure D.2** on page **102**.

## **Abstract**

Those who are not experts in the field of accounting will most probably be of the opinion that interest should be expensed and therefore reduce profits. However, for financial periods beginning on or after 1 January 2009, the capitalisation of borrowing costs (interest) incurred on certain qualifying assets became mandatory for companies applying International Financial Reporting Standards (IFRS). Apart from the practical implications of this change, some technical questions remain unanswered by IAS 23 *Borrowing Costs*, and since it is now mandatory to capitalise borrowing costs, it might be worthwhile to take a deeper look at the requirements of this standard. The study reveals that knowledgeable Financial Accounting academics were quite divided in their opinions regarding the finer technical details of the revised standard, for example the period that would constitute a “substantial period of time” as mentioned by the standard when defining qualifying assets. These differences in opinion might prove that accountants with equal knowledge may interpret the standard differently, which might lead to confusion and inconsistency in external reporting; a clear infringement of the modern plea towards accounting harmonisation. The findings of this research could prompt standard-setters to provide clearer guidance in the revision of future standards on borrowing costs in various different accounting frameworks, or even of other standards with similar uncertainties. In the instances where participants did agree on the correct accounting treatment, the findings in this research could also be used as guidance for what the correct accounting treatment should be for various scenarios. This could be useful, amongst others, to accountants in practice, auditors, text book and guidance document authors, university lecturers and providers of continuing professional development (CPD) training.

## **Keywords**

Borrowing costs

Capitalisation

IAS 23

Interest

International Financial Reporting Standards (IFRS)

Qualifying asset

Technical uncertainties

United States Generally Accepted Accounting Principles (US GAAP)

## **1. Introduction**

Generally Accepted Accounting Practice standards were issued to help reduce the differences in accounting practices used by accountants (Everingham, Kleynhans & Posthumus, 2007:4). Over the course of a few years, one such standard that was developed was IAS 23 *Borrowing Costs*. The standard deals with the treatment of borrowing costs incurred on the financing of certain “qualifying assets”. Examples of such costs given by Sowden-Service (2009:483) include interest incurred on loans, amortisation of discounts or premiums, finance charges on finance leases, exchange differences on foreign loan accounts and dividends on preference shares classified as liabilities.

The standard was not accorded much attention in the past, as the norm was to expense the borrowing costs and capitalisation was only an allowed alternative (Enslin 2008:22). However, IAS 23 was revised, and for reporting periods beginning on or after 1 January 2009, the capitalisation of borrowing costs on qualifying assets is no longer merely an allowed alternative, but a requirement (Cairns, 2009:64; Deloitte Touche Tohmatsu, 2008).

Four members of the European Financial Reporting Advisory Group (2007), however, believed that the costs involved in making this change would exceed the benefits that will arise; their reasoning being that the capitalisation approach, as set out in IAS 23, displays a number of weaknesses. One such weakness, for example, is the uncertainty regarding the accounting for borrowing costs arising from the refinancing of qualifying assets, which results in a questionable allocation of borrowing costs to qualifying assets (European Financial Reporting Advisory Group, 2007:7).

According to Enslin (2008:23), the theory of the standard remained greatly untested in practice so that grey areas might exist. One such area is that the term “substantial period of time” (as encountered in the definition of “qualifying asset”) is not defined by IAS 23 and professional judgement is needed in order to determine the length of such a period. This might not improve comparability of financial statements since one person’s judgement might differ significantly from the next.

It is clear from the above discussions that there may be various grey areas relating to certain technical matters in the revised standard, which entities may find challenging in practice. The aim of this study is to obtain the opinions of South African academics in the Financial Accounting field relating to the uncertainties arising from the application of the requirements of the revised standard concerning borrowing costs, and to make suggestions, based on their opinions, regarding the most appropriate accounting treatment for such grey areas.

The rest of the article is structured as follows: Firstly, the extant literature relevant to borrowing costs is reviewed; subsequently, the research methodology is presented and data analysis techniques are discussed; and lastly, the results are discussed, conclusions are drawn and the implications of the study are highlighted.

## **2. Literature Review**

A review of recent literature revealed extremely few references to borrowing costs specifically, especially with regard to empirical peer-reviewed studies. A wider search on IFRS matters in general uncovered the result that current literature extensively addresses IFRS adoption and convergence issues, but there is little research on technical accounting matters, with the exception of fair value accounting and taxation, which are addressed to some extent. This creates an opportunity for research studies to address the gap in the literature regarding technical accounting issues; in the case of the current study, specifically in respect of the capitalisation of borrowing costs and, consequently, capitalisation of expenditure in general. The lack of technical research may possibly be attributed to a general perception that academic research does not play a major role in the standards-setting process. However, by drawing inferences from prior research findings, Fülbier, Hitz and Sellhorn (2009) emphasise the role that academic research could play in the International Accounting Standard Board's (IASB's) standard-setting process.

### **2.1. Expenditure in general: to capitalise or not to capitalise**

The debate on when to capitalise versus when to expense is an old one and standards have been revised numerous times over the decades to determine the "right" answer. In a study by Lantto and Sahlström (2009) on the impact of IFRS adoption on key financial ratios, they explained that domestic accounting standards in countries such as Austria, Belgium, Finland, France, Germany, Greece, Italy, Portugal and Spain allowed companies to capitalise research costs and other internally generated intangible assets. Current day IFRS, however, requires the expensing of such costs and a study by Gjerde, Knivsflå and Sættem (2008) supported the value-relevance of this capitalisation approach. However, there was a time where companies could exercise free choice in capitalising such costs and studies have revealed that managers may influence the capitalisation of costs to restore earnings to levels before a mandated accounting change, for example, by manipulating depreciation charges (Dhaliwal & Heninger, 1999; Beatty & Verrecchia, 1989).

In a study by Ding, Richard and Stolowy (2008) regarding the accounting treatment of goodwill, that spanned more than a century, these authors concluded that the gradual move from expensing goodwill to capitalising goodwill reflects the shift from a stakeholder model to a shareholder model,

which leads to the preference for short-term rather than long-term profit. This may also explain the current trend of capitalising expenditure rather than expensing it, for example, the proposed requirement for capitalising operating leases. Some authors have already studied the impact that the capitalisation of operating leases may exert on financial statements (Bryan, Lilien & Martin, 2010; Durocher, 2008).

Looking specifically at the capitalisation of borrowing costs, a study by Kvaal and Nobes (2010) found significant evidence that pre-IFRS national practices continued where this was allowed by IFRS. As part of this study, they established that Australian and Spanish companies were more inclined than others to capitalise borrowing costs because their pre-IFRS domestic accounting standards mandated such a treatment. However, the revised IAS 23 eliminated the choice of expensing borrowing costs as a result of the convergence between IFRS and United States Generally Accepted Accounting Principles (US GAAP). Miller and Becker (2010) confirmed that US GAAP is rules-based as opposed to the principles-based IFRS. This may lead one to speculate over the real reason for eliminating the choice in IAS 23: that is, the result of a political process in terms of which a new “rule” was incorporated into IFRS to move IFRS closer to US GAAP, versus an economic one where accurate and useful accounting was the main goal.

## **2.2. Possible technical uncertainties in IAS 23**

Grant Thornton International (2006) requested that a discussion paper be issued, where the specific requirements for the application of both expensing and capitalising borrowing costs were explored, before the revised IAS 23 was issued. CPA Australia (2006) proposed that further changes needed to be made to IAS 23, at least in order to achieve consistency with SFAS 34 (the US GAAP standard on borrowing costs), before issuing the revised IAS 23. PricewaterhouseCoopers (2006) felt that principles of capitalisation should be readdressed in a manner that would assist preparers to deal with the current practical difficulties faced when applying the existing literature. These requests and proposals were made just before the issuing of the revised IAS 23 and serve as a reliable indication that there might be uncertainties regarding the technical application of IAS 23, and that more guidance may consequently be needed.

According to O’Riordan (2006:22), the basic purpose of IAS 23 is to prescribe the treatment of borrowing costs incurred in financing the acquisition, construction or production of qualifying assets. A qualifying asset is defined by the International Accounting Standards Board (2009:1428) as “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale”. Enslin (2008:22) stated that a “substantial period of time” is not defined by IAS 23. This

vagueness has the potential to lead to confusion among those who apply IAS 23 (McClelland, 2006).

IAS 23 (International Accounting Standards Board, 2009:1428) excludes from its scope inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis. Maturing whisky (Deloitte Touche Tohmatsu, 2007), as well as wine, could be such an example. Enslin (2008:23) initially argued that every year's vintage is different and therefore wine does not qualify to be excluded. After reading the basis for conclusions in IAS 23, he noted that the reason for the scope exclusion was based on the fact that the costs of allocating the borrowing costs may exceed the benefits obtained. However, he still arrived at the conclusion that inventories such as wine should not qualify for the scope exclusion because the borrowing costs can reasonably be allocated to each year's vintage (Enslin, 2008:23).

Capitalisation of borrowing costs should be suspended where the active development of qualifying assets is interrupted for an extended period (Lubbe, Modack & Watson, 2009:380). However, according to Vorster, Koornhof, Oberholster, Koppeschaar, Coetzee, Janse van Rensburg, Binnekade, Leith, Hattingh & De Klerk (2009:512) as well as the Australian Accounting Standards Board (2006), IAS 23 does not explain the term "extended period" and therefore judgement is often required to determine whether a period is extended or not. As this is not clear from IAS 23, significant differences in opinion might exist regarding when suspension should occur and when not.

The International Accounting Standards Board (2009:1432) offers the following guidance in IAS 23: "An entity also does not suspend capitalising borrowing costs when a temporary delay is a *necessary* part of the process of getting the asset ready for its intended use or sale." It also mentions the phrase "common events", which is linked with continuing capitalisation. Based on this, Enslin (2008:23) posed the question as to whether something that is "uncommon" necessarily means that suspension should take place. In the same way, the meaning of the word "necessary" is also debatable.

Vorster *et al.* (2009:512) and Enslin (2008:23) noted that, if circumstances leading to the suspension of activities are under the control of management, this would indicate that they do not form part of the normal process and therefore capitalisation of borrowing costs should be suspended. However, in cases where events are both uncommon (supporting suspension) and beyond the control of management (not supporting suspension), a paradox arises. If accountants apply the notion that management's ability to control the events affects the decision to suspend

capitalisation of borrowing costs, they might not suspend capitalisation in cases where uncommon or unnecessary events are beyond the control of management, which may not be the intention of IAS 23.

Sappi (2006) raised the concern that a potential issue surrounding the application of capitalisation would be the allocation of borrowing costs to various components of a single qualifying asset. No guidance is provided within IAS 23 concerning a preferred method of allocating borrowing costs amongst various components of a qualifying asset; this might lead to inconsistencies in its application between various companies.

The South African Institute of Chartered Accountants (2006) called for specific guidance on whether internally generated intangible assets fall within the scope of a qualifying asset as defined by IAS 23. IAS 38 (the standard on intangible assets) states that an intangible asset may only be recognised in the development phase if certain criteria can be demonstrated (Stainbank, Oakes & Razak, 2009:C18:P6). This raises the question as to whether borrowing costs pertaining to internally generated intangible assets should only be capitalised once the requirements of the development phase can be demonstrated. To add to these complexities, accountants may also be uncertain regarding the arithmetical treatment of compounded interest in such circumstances. A study by Giacotto (1989) explored some of the complexities when dealing with compounded interest in general, which indicates that it may be valuable to explore this issue further.

### **2.3. Judgements in accounting and a need for clarity**

A consistent cross-firm application of accounting standards is sought in all major accounting regimes. However, judgements are an integral part of accounting in general, and even more so in principles-based accounting standards like IFRS (Schmutte & Duncan, 2009:32; Psaros & Trotman, 2004). IFRS standards regularly contain words and phrases like “substantial” and “more likely than not” – the application of which is left to the professional judgement of the accountant (Stevenson Smith & Von Bergen, 2009).

However, an analysis by Wüstemann and Wüstemann (2010) concluded that a consistent application of accounting standards can only be ensured if the accounting standards themselves are internally consistent. Moreover, it was found that a consistent application presupposes the existence of specific guidance in order to frame management's judgment. Wüstemann and Wüstemann (2009) argued further that the reliance on principles only – as requested by many authors in the accounting literature – fails to ensure a consistent application because it allows management to exert judgement differently in identical cases. In a study on companies' disclosures regarding restatements in

financial statements, Plumlee and Yohn (2010) supported these claims by concluding that, for those restatements attributed to some characteristic of the accounting standards, the primary contributing factor is the lack of clarity in applying the standards and/or the proliferation of the literature because the original standard lacked clarity.

From the above discussion it is clear that there are some technical grey areas within IAS 23 for which guidance might be needed. The research objectives in this study are therefore:

- To obtain the opinions of South African accounting academics relating to the technical uncertainties with the application of the requirements of the revised IAS 23.
- To suggest the most appropriate accounting treatment of the technical uncertainties identified.

The hypothesis, based on the above research objectives, is that a variety of technical uncertainties exists in the application of IAS 23 because the standard has remained relatively untested in practice, leading to various grey areas when examining the theory of the standard.

The process of developing and revising accounting standards is often viewed as a top-down approach where standard-setters “force” rules onto accountants all over the world (Sikka, 2007; Rodgers, 2002). This research study gathered the opinions of some of the most technically knowledgeable accountants in South Africa: hence the results obtained could shed some new light on technical uncertainties in the standard, which could ultimately influence future revisions of this standard and even other International Financial Reporting Standards (IFRSs) where similar issues are encountered.

### **3. Methodology**

A review of the relevant literature was conducted in order to identify possible technical obstacles in the application of the revised IAS 23, which mandates capitalisation of borrowing costs incurred on qualifying assets.

The rest of the study largely follows a quantitative methodological paradigm since the research design takes the form of an empirical survey (Mouton, 2001:152-153; Davies, 2007:188; Lategan, Hay, Holtzhausen, Truscott & Vermeulen, 2005:19-25).

The questionnaire consisted of five demographic questions and 15 questions aimed at gathering the opinions of Financial Accounting academics on various technical issues found within the revised IAS 23. Each of these 15 multiple-choice type questions required that an opinion be selected as to

the correct answer for a given technical problem. An option was also made available in circumstances where a participant may have felt that none of the given options were correct. Participants were also encouraged to contribute qualitative comments above and beyond the standard options that were available in the questionnaire.

The target population consisted of the Financial Accounting academics from all the universities in South Africa that are accredited by the South African Institute of Chartered Accountants to offer a chartered accountancy programme. An e-mail was sent to each identified lecturer with the questionnaire attached. Participants completed the questionnaire and added relevant comments, after which it was returned to the researcher.

A total of 24 respondents completed the questionnaire after regular follow-up correspondence with non-respondents. Some reasons for not attracting more responses could include the high work-load experienced by the academics and the fact that not all Financial Accounting academics may be able to provide detailed technical responses on IAS 23 matters, since the majority of such academics specialise in certain topics, which may not include that of borrowing costs.

Apart from the above, the questionnaire was also sent to the technical department of a specific South African branch of a global audit firm. A total of three additional respondents completed the questionnaire. For two reasons, firstly because this department within the firm addresses, amongst others, the technical accounting uncertainties that auditors encounter on a daily basis, and secondly because this firm offers academic training for students in the process of completing their Honours degrees / Certificate in the Theory of Accountancy (similar to the training provided by universities), the technical knowledge possessed by personnel within this department, can be regarded as at least equal to that of Financial Accounting lecturers at universities. A total of 27 respondents therefore participated in this study, all of which are regarded as possessing similar technical knowledge of IAS 23 (arguably the greatest degree of technical knowledge in South Africa).

The answers to each questionnaire were captured in a spreadsheet; the percentages of each option chosen by the participants, relative to other options under the same question, were calculated. Based on these percentages, the accounting treatment most favoured by the participating academics could be identified for each technical uncertainty. Descriptive statistics were therefore obtained from this data analysis procedure: the interpretation thereof was limited to only the participants in the study; that is, no attempt was made to generalise these statistics to the total population. The qualitative comments made by each academic were also especially valuable and have been summarised and reported where relevant.

Even though no inferential statistics were analysed because of the structure of the questionnaire, valuable information regarding the interpretation of technical uncertainties in IAS 23 was obtained by analysing the responses of a fair number of individuals with perhaps some of the best technical accounting knowledge and experience in South Africa, especially owing to relevant qualitative comments furnished by them on certain issues. Therefore, even though the study largely followed a quantitative design, it did also contain some qualitative elements based on the following definition of “qualitative research” by Henning (2004:5): “a type of inquiry in which the qualities, characteristics or the properties of a phenomenon are examined for better understanding and explanation”.

## **4. Results**

### **4.1. Demographic placement of participants**

The following useful demographic information was gathered by analysing the data obtained from the questionnaire:

Twenty-three participants (including the respondents from the auditing firm) were members of the South African Institute of Chartered Accountants. One was a member of the South African Institute of Professional Accountants (SAIPA), one was a member of both the South African Institute of Chartered Accountants and the Chartered Institute of Management Accountants, while one was a member of both the South African Institute of Chartered Accountants and the Independent Regulatory Board of Auditors. One respondent neglected to indicate his/her membership of a professional body.

These numbers are a decent indication of the quality of the participants’ technical knowledge, as a high level of technical competence is needed to become and remain a member of these professional bodies. The period for which the participants had been members ranged from one month to 37 years, with an average of 12 years. In addition, the period for which the participants had been teaching Financial Accounting was also an indication of their technical knowledge and experience. This ranged from six months to 27 years, with an average of 9 years. This also indicates that participants stemmed from a variety of younger and older generations. Therefore, the opinions gathered did not represent only the ideas of one generation, but instead reflected a wide range of views. The practical experience (outside of academia) of participating lecturers was 5 years on average, ranging from 0 to 25 years.

## 4.2. Technical findings

The specific questions asked of the participants are listed in Appendix A. The findings are presented below in the same order as the questions in the questionnaire (Appendix A).

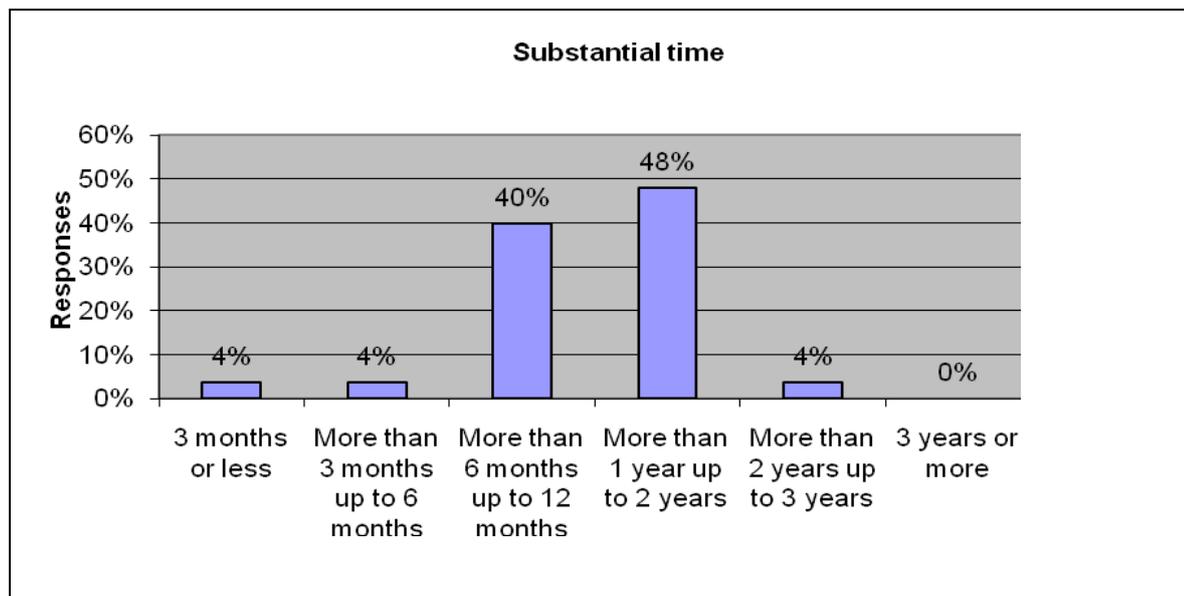
### 4.2.1. Substantial period of time

#### Purpose

The definition of a qualifying asset makes use of the phrase “substantial period of time”. Therefore, whatever a person regards as “substantial”, will influence his or her decision about what will constitute a qualifying asset, which will ultimately determine whether borrowing costs are capitalised or not.

#### Findings

Chart 1: Substantial Time



Four percent (4%) of participants felt that three months or less is long enough to be regarded as a substantial period of time. Another four percent (4%) believed that a period of more than three months is more appropriate, while yet another 4% leaned towards a period of more than two years. There were no participants who felt that a substantial period should be as long as three years or more. Forty-one percent (41%) of the participants felt that a period of more than six months would be an appropriate measure of a substantial period, whereas a further 48% were of the opinion that more than one year is a more appropriate measure.

One of the participants believed that it might not be appropriate to link a specific length of time to the word “substantial”. According to this participant, each situation should be assessed on a case by

case basis, which may require the use of management's professional judgement. Once management has decided on a time frame for a class of asset or type of project, this should be applied consistently. In other words, the nature of the asset or project should be considered and the question should be asked whether the time period itself is an integral part of construction for the type of project. If the answer to this question is yes, then one should capitalise borrowing costs incurred on the financing of such a project.

#### **4.2.2. Scope exclusion of wine**

##### **Purpose**

The question aimed to clarify whether wine (held as inventory) will qualify for the scope exclusion in IAS 23 relating to inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

##### **Findings**

The majority (74%) of participants felt that wine qualified for the scope exclusion. However, 26% of participants did not agree. These latter based their view on the purpose of the scope exclusion, being that it could be impracticable to allocate borrowing costs to small items that are manufactured quickly and repetitively and to reduce the administration burden for entities that produce high volume products with short turnaround times. Undoubtedly, wine takes some time to produce and it should be practical to allocate borrowing costs to the wine because the "large quantities" rather relate to large volumes (litres, gallons or bottles) of wine which could be stored in bulk in large containers. It may therefore be fairly easy to allocate borrowing costs because the number of containers is not as great as the number of litres/gallons of wine produced. For example, if 1 000 wine bottles are bottled from one container, then the same amount of borrowing costs can be capitalised for each bottle because all 1 000 bottles (a "large quantity") were produced during the same time period (a different cultivar every year). Therefore, based on this principle, if wine takes a substantial period of time to produce, it will probably be a qualifying asset. The substance of the item should therefore be considered. Also, management will need to take into account the type of product and its sales volume in order to evaluate whether the scope exclusion will be applicable or not (the so-called "substance over form" accounting principle).

The motivation that the other 74% furnished for the exclusion of wine was that, although a different cultivar may be produced every year, wine is still produced in large quantities on an annual basis (a repetitive process). The administrative burden could be too great in these circumstances. Moreover, the capitalisation of borrowing costs on these types of items will not add any value to the users of

financial statements, as this would be a costly exercise. Wine, with all its nuances and various stages of production and, in certain cases, maturity periods before bottling and sale, could be incredibly onerous to monitor. This category of participants therefore felt that the costs of this calculation would grossly exceed the benefit derived by users of the financial statements.

A valuable comment received by one of the participants was that SFAS 34 (the US GAAP standard on borrowing costs) does not allow such borrowing costs to be capitalised. Since an attempt is being made to promote convergence between International Financial Reporting Standards (IFRS), of which IAS 23 forms part, and US GAAP, this scope exclusion was introduced. The participant felt that this was more of a political compromise than an approach driven by the need to ensure pure application of the spirit of the standard. In the case of a wine maker, the scope of IAS 23 would allow him to expense the borrowing costs but does not make it mandatory. Thus, while the wine maker is entitled to avoid capitalisation of the borrowing costs, it is not compelled to do so.

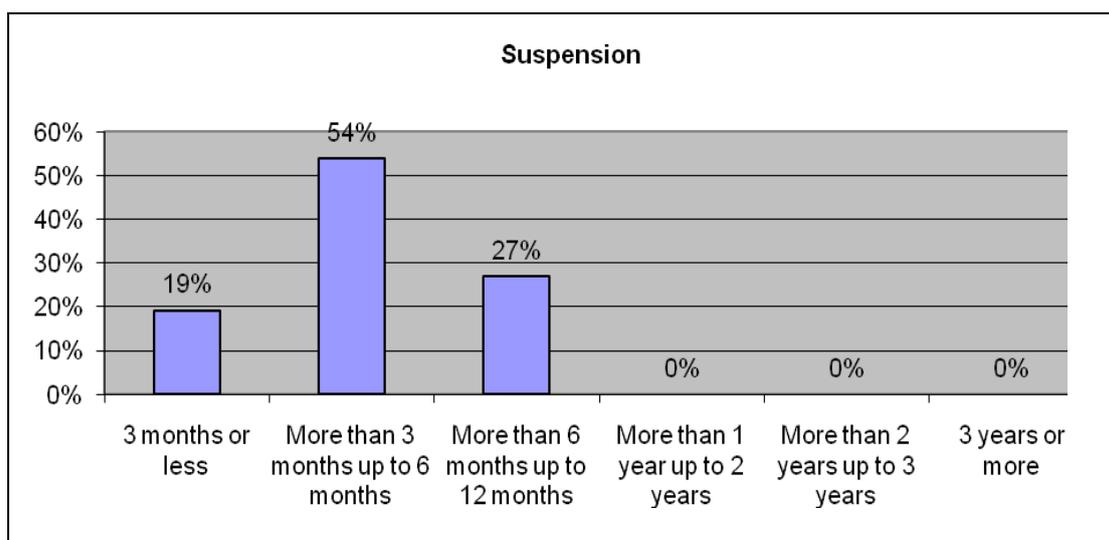
#### 4.2.3. Suspension of capitalisation: Meaning of an extended period

##### Purpose

This question was intended to ascertain the length of time that would be regarded as an extended period during which active development of the qualifying asset is suspended, and hence during which capitalisation of borrowing costs would be suspended.

##### Findings

Chart 2: Suspension



The slight majority opinion (54%) of participants regarding the meaning of an “extended period” was that it referred to more than three months. However, some participants (27%) felt that more

than six months is more appropriate whereas 19% felt that less than three months can be regarded as an extended period.

#### **4.2.4. Suspension of capitalisation: A common but avoidable event**

##### **Purpose**

This question attempted to determine whether suspension of capitalisation of borrowing costs should take place when a common but avoidable event that causes a delay in the construction or production of a qualifying asset occurs. In other words, it is common for such an event (such as high water levels during construction of a bridge over a river) to occur at a certain point in time (e.g., during the rainy season), but this event could have been avoided if the construction/production had started either earlier or later.

##### **Findings**

Seventy-eight percent (78%) of participants were of the opinion that suspension should not take place in such circumstances. In other words, as long as the event is common, it appears that the fact that it could have been avoided was considered to be irrelevant. This, however, does cause a larger asset to be recognised due to the capitalisation of borrowing costs.

Among the 22% of participants who held a different opinion, a comment was made that the example in paragraph 21 of IAS 23 (similar to the scenario in the questionnaire) probably refers to a situation where the delay is an inevitable part of the construction or production process. In the scenario presented in the questionnaire, the delay was not an inevitable part of the process, because the construction could have taken place during a different time so as to prevent the delay.

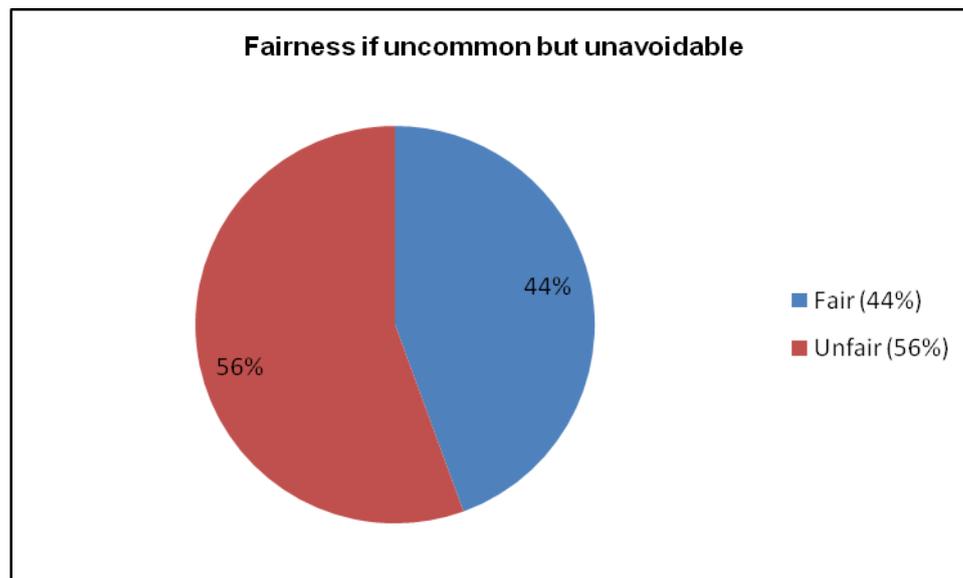
#### **4.2.5. Suspension of capitalisation: An uncommon but unavoidable event**

##### **Purpose**

In the previous section it was determined that the factor of whether an event is common or uncommon, plays a more important role in the suspension decision compared to whether the event is avoidable or not. The question in this section, however, sought to gather the participants' views regarding the fairness of the strict application of IAS 23 when an event is uncommon, but, due to unforeseen circumstances, is also unavoidable.

## Findings

**Chart 3: Fairness if uncommon but unavoidable**



The views on whether unavoidability is fair or unfair were separated by a relatively small percentage difference; however, a slight majority of participants believed that it is unfair to be unable to capitalise borrowing costs when an event is uncommon but also unavoidable and therefore does not fall under the entity's control.

The main argument of those who considered this to be fair was that the costs would be unexpected and would not have been included in the financing arrangement as the entity would not have budgeted for this. From the viewpoint of the entity, this would reduce its profits and therefore the borrowing costs should be expensed. Also, one needs to take into account that the costs associated with holding an incomplete asset cannot be capitalised.

Arguments for unfairness included the overriding accounting principle of fair presentation. The carrying amount of the asset should not exceed the future economic benefits that are expected to be derived from it. One would assume that the future economic benefits derived from both assets (one experiencing delays due to an uncommon event and one experiencing delays due to a common event) should be the same. Consistent treatment of borrowing costs should also be considered because the location of the qualifying asset should not influence the cost of the asset; neither should a natural event, such as high water levels during construction, determine the carrying amount of an asset.

#### **4.2.6. Capitalisation of the financing of additional work due to an uncommon event**

##### **Purpose**

This question evaluated the persuasive power of the word “common”, which is used as an example in IAS 23 in deciding whether or not to capitalise borrowing costs in certain scenarios. If an event is “uncommon”, accountants may speculate whether this extends as far as to preclude capitalisation of borrowing costs on the financing of additional work due to this uncommon event. The purpose of this section was to address this uncertainty.

##### **Findings**

Eighty-one percent (81%) of participants believed that finance costs arising from additional financing, due to additional work necessitated by an uncommon event, should also be capitalised. In contrast, 19% of participants felt that capitalisation should not take place for the same reason as that for not capitalising the borrowing costs on the original financing, being the occurrence of an “uncommon” event, which precludes capitalisation, as already discussed.

As one participant noted, IAS 23 does not prohibit these borrowing costs from being capitalised. Another participant noted that if the additional work itself qualifies for capitalisation, the borrowing costs should be capitalised. If the additional work is a replacement of previous work, then capitalisation should not take place.

#### **4.2.7. A common event is always a necessary part of the production process**

##### **Purpose**

An example given in IAS 23 suggests that, if an event is common, suspension of the capitalisation of borrowing costs will not take place when active development of the qualifying asset is suspended. Further guidance is also given, stating that a temporary delay, which is a necessary part of the process, will not lead to suspension. In summary, this could be interpreted as stipulating that a common event, which is also an event that is a necessary part of the process, will not lead to suspension. The question that is therefore left to be answered is whether any common event will always be a necessary part of the production/construction process. If not, some doubts may arise regarding which one of the two factors (commonality vs. necessity) will be preferred in deciding whether or not to suspend capitalisation of borrowing costs in such circumstances. For example, if the event is uncommon but a necessary part of the process, uncertainty may arise regarding whether capitalisation will be suspended due to the fact that the event is “uncommon”, or whether capitalisation will continue due to the fact that the event is “necessary”.

## Findings

The majority (67%) of responses indicated that a common event does not always constitute a necessary part of the process. One participant commented that the key issue to be considered is whether the event is a direct part of the production process and whether it is controllable by management. For example, a nation-wide strike by employees is not controllable, but if the strike occurs at the local entity alone, it might be considered a factor contributing to inefficiency, and thus borrowing costs incurred during periods of such delays ought to be expensed because the strike is controllable by the client and could have been avoided. The alternative would be to test the asset for impairment; hence the cost of the inefficiency will be recorded in profit or loss through an impairment loss.

### 4.2.8. Circumstances not under management control

#### Purpose

This question attempted to establish whether or not the participants were of the opinion that capitalisation should be suspended if circumstances leading to the suspension of activities for an extended period of time are not under the control of management.

#### Findings

**Chart 4: Management control and suspension**



Participants leaned more towards the view that suspension of capitalisation should take place for circumstances under the control of management. One participant (representing 4% of respondents) indicated that he would perhaps suspend capitalisation in such circumstances, but commented that

he would lean more towards not suspending it. According to him, one should look at the particular circumstances and consider other IAS 23 principles in addition to this fact.

#### **4.2.9. Uncommon event and capitalisation**

##### **Purpose**

By using an extreme example, this question was intended to determine what would constitute a common and necessary event and it also probed further by exploring the outcome if the event is neither common nor necessary. The example that the participating academics had to assess was that of the untimely death of an engineer in charge of a construction project and whether this would cause capitalisation of borrowing costs to be suspended or not.

##### **Findings**

Seventy-seven percent (77%) of participants indicated that capitalisation should be suspended in such a scenario. They held the view that, in normal circumstances, death cannot be regarded as a common or necessary part of the construction process. Twenty-three percent (23%) of participants, however, felt that capitalisation should be continued. According to them one might argue that, because it is the engineer in charge who died, the project might not be able to continue without him/her (or just until she/he could be replaced); therefore the delay is a necessary part of the construction process.

#### **4.2.10. Specific loan not yet utilised**

##### **Purpose**

This question explored what the correct accounting treatment should be when a specific loan is incurred to finance a qualifying asset, but this loan has not yet been utilised for the initial period for which activities are undertaken (e.g. the first year of the construction process). Other funds are used for this purpose during this initial period, but interest is already accruing on the specific loan.

##### **Findings**

Seventy-four percent (74%) of participants believed that the interest incurred on the specific loan (even though it has not yet been utilised to cover expenditure incurred on the qualifying asset), should be capitalised. Their argument was that IAS 23 caters for this situation by allowing the capitalisation of borrowing costs on specific loans, but that this amount is then reduced by the investment income earned on surplus/unutilised funds. Therefore, effectively no borrowing costs are capitalised (or a very small amount is capitalised, depending on the difference in the borrowing

rate compared to the rate of return on investment). This reflects the fact that these borrowing costs were not directly attributable to preparing the asset for its intended use or sale. As an aside, it is interesting to note that SFAS 34 (the US GAAP standard) does not allow the reduction of capitalised borrowing costs by investment income earned on surplus funds (International Accounting Standards Board, 2007:1-2). This cast some doubt on the usefulness of the Short-term Convergence Project between IFRS and US GAAP, of which the revision of IAS 23 was a direct consequence.

#### **4.2.11. Capitalisation of compounded interest when activities are deferred**

##### **Purpose**

According to IAS 23, an entity can only start capitalising borrowing costs once activities that are necessary to prepare the asset for its intended use or sale have been undertaken. Therefore, when a specific loan is incurred, say in the first year (and compound interest applies), but activities only commence in the second year, one can only start capitalising in the second year. The question is therefore whether the compounded interest (which includes interest on interest for the first year) should be capitalised in the second year, or only the simple interest relating to the second year, bearing in mind that activities only started in the second year.

##### **Findings**

The majority of participants (67%) were of the opinion that the compounded interest (including the interest on interest incurred in the first year), should be capitalised in the second year and not only the interest purely relating to the principal amount outstanding for the second year (i.e., un-compounded). One argument for this view was that the *actual* cost of getting the asset ready for use or sale is the compounded interest itself. Nineteen percent (19%) of participants felt that only the simple interest relating to the second year should be capitalised while a further 15% felt that a different amount should be capitalised. This different amount was calculated by deducting investment income resulting from the temporary investment of surplus funds from the borrowing costs to be capitalised. In other words, the amount of borrowing costs to be capitalised would be the total compounded interest less any investment income received thereon. Therefore the said 15% of participants can also be viewed as having favoured capitalising the compounded interest in the second year, bringing the total percentage of participants who held this view to 82%.

#### **4.2.12. Capitalisation of compounded interest when suspension occurs sometime during the period**

##### **Purpose**

This question was similar to the one in the previous section (4.2.11), but approached the scenario from a different angle. The situation that was presented to the participants was as follows: if, in the first year, only seven months of borrowing costs were capitalised due to the fact that capitalisation was suspended for a five month period at some stage during the year, participants had to decide whether a full year's compounded interest needs to be capitalised in the second year, or only the simple interest for the second year, in addition to only seven months' worth of interest on interest incurred in the first year.

##### **Findings**

Sixty-nine percent (69%) of participants were of the opinion that a full year of compounded interest should be capitalised in the second year. Twenty-three percent (23%) felt that only the simple interest for the year plus seven months' worth of interest on interest incurred in the first year should be capitalised. A small minority (8%) felt that only the interest amount of the first year should also be capitalised in the second year.

#### **4.2.13. Indirect borrowing costs and parts**

##### **Purpose**

The aim of this question was to determine the effect that different parts/components of a qualifying asset, which all take different lengths of time to complete, would have on the capitalisation of borrowing costs. The impact of the assembly of these parts on the borrowing costs to be capitalised was also to be considered.

##### **Findings**

Seventy percent (70%) of participants held the view that the completion of components should not influence the borrowing costs to be capitalised. If, for example, there are five components of a machine, and each component is completed at a different point in time, capitalisation of the portion of the borrowing cost that relates to the completed component should not be ceased. Twenty-two percent (22%) of participants however felt that, when each component is completed, the portion of borrowing costs related to the completed component should not be capitalised any further. This might be based on the principle in IAS 23 which states that capitalisation shall cease when substantially all activities necessary to prepare *that part* for its intended use or sale are completed.

IAS 23 also states, however, that each part must be capable of being used while construction continues on the other parts, which therefore swayed the other 70% of participants towards the response that the capitalised borrowing costs should not be proportionately reduced.

One participant (4%) felt that capitalisation should not take place at all because the warehouse (used as an example in the questionnaire; refer to question 13 in Appendix A) is not a qualifying asset whereas another participant (4%) noted that borrowing costs should be capitalised net of investment income.

Sixty-seven percent (67%) of participants felt that the capitalisation of the borrowing costs should also take place during the time of assembly. The said costs capitalised during this period should not only be the borrowing costs related to certain parts/components, but the borrowing costs that relate to the full financed cost of the assembled asset.

Seven percent (7%) however believed that capitalisation should not take place during the period of assembly. Eleven percent (11%) of participants held the view that 12 months' worth of interest should be capitalised even though the assembly period is only two months. A further two participants (7%) responded that the borrowing costs to be capitalised should only relate to the period of assembly, but also went as far as indicating that only a fifth of the borrowing costs incurred in this period should be capitalised (one out of five uncompleted parts; refer to question 13 in Appendix A). The other 8% of responses were based on the fact that borrowing costs should be calculated net of investment income (4%) and that no amount should be capitalised since the warehouse is not a qualifying asset (4%).

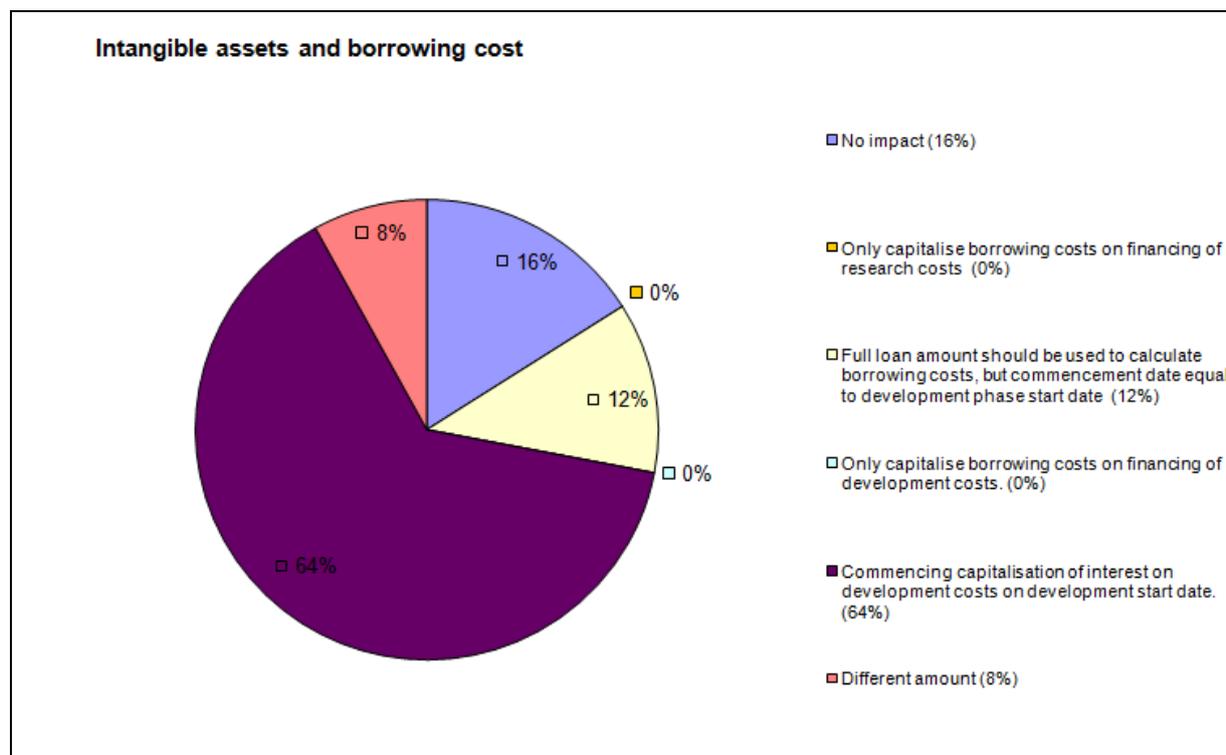
#### **4.2.14. Internally generated intangible assets and borrowing costs**

##### **Purpose**

The purpose of this question was to determine the impact that the rules of IAS 38 *Intangible assets*, relating to the research and development phases of internally generated intangible assets, would have on the capitalisation of borrowing costs.

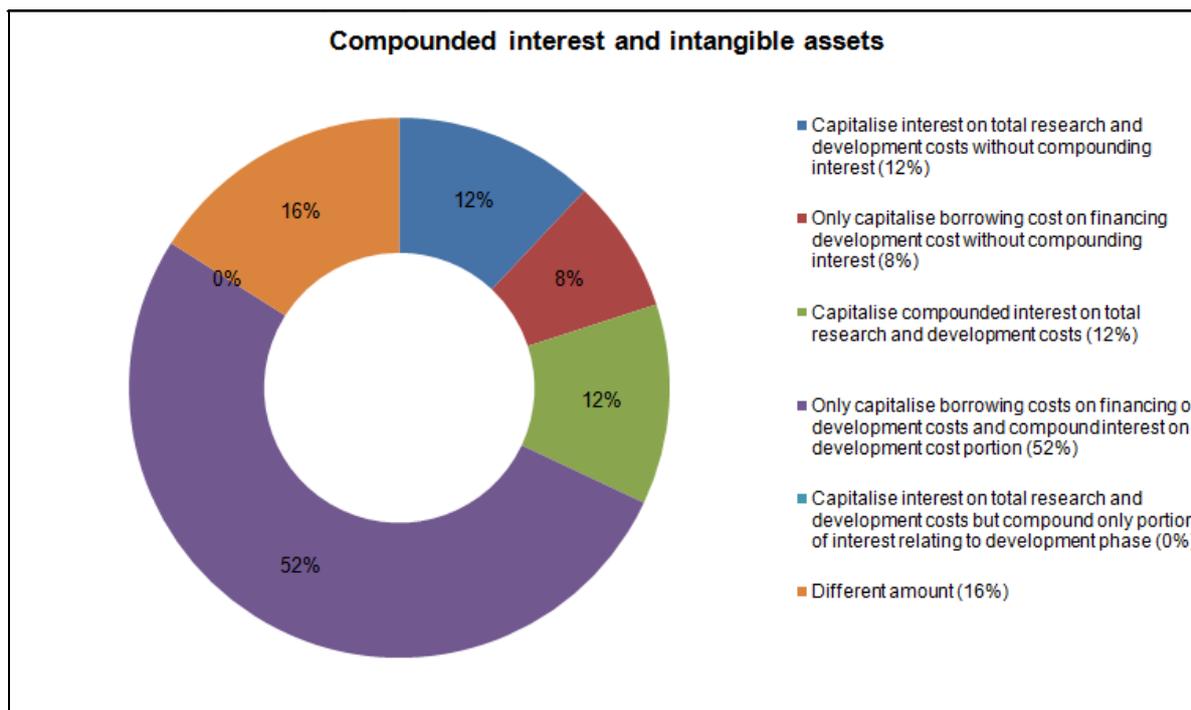
## Findings

Chart 5: Intangible assets and borrowing cost



Firstly, when considering the impact while disregarding the effect of compounded interest (in other words only taking into account the first year of activities being conducted), 64% of participants believed that capitalisation of borrowing costs would be affected by the IAS 38 principles relating to research and development. More specifically, the impact will be that the full loan amount will not be used in the calculation, but only the portion relating to expenditure incurred during the development phase. The commencement date of capitalisation of borrowing costs will also be affected because the start of the development phase will be used as the commencement date and not the date that the activities actually began (i.e. when the research phase was originally started). Sixteen percent (16%) of participants believed that IAS 38 should not impact on the capitalisation of borrowing costs at all, whilst a further 12% believed that the loan amount used in the calculation should not be affected (i.e. capitalised borrowing costs should be based on the full loan amount, not just the development phase portion), but that only the commencement date would be different from the norm (i.e. the capitalisation of borrowing costs is commenced on the starting date of the development phase).

**Chart 6: Compounded interest and intangible assets**



Secondly, 52% of participants agreed that interest relating to only the development cost should be compounded. In other words, proportionate compounding relating to only the development phase should take place. Eight percent (8%) believed that no compounding should take place, and furthermore that only the development cost amount should be used to calculate the interest to be capitalised. Twelve percent (12%) felt that interest on the total research and development costs should be capitalised without compounding the interest. Another 12% held the view that capitalisation of the full financing (for both research and development) should take place and that interest should be compounded.

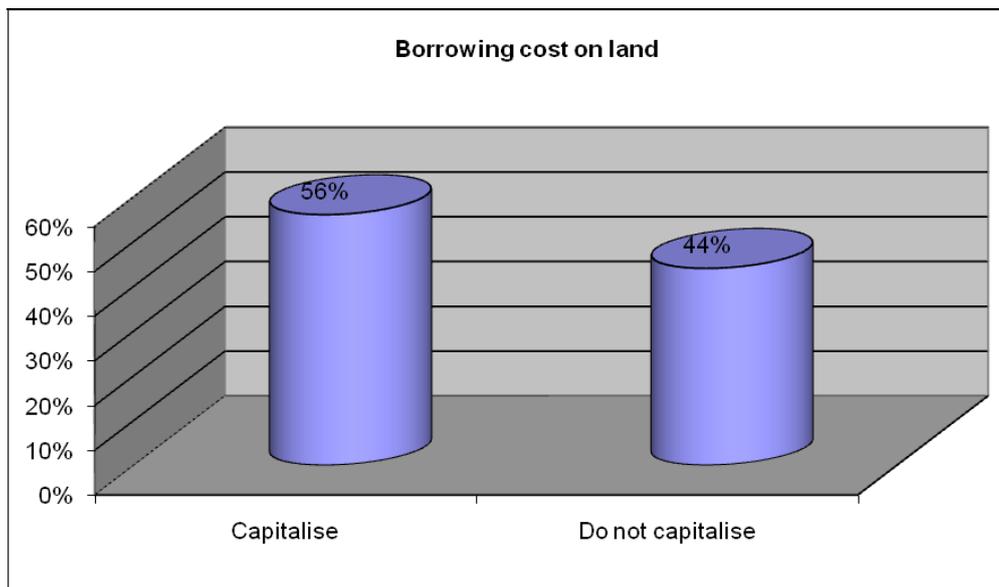
#### **4.2.15. Qualifying assets and land**

##### **Purpose**

The aim was to establish whether borrowing costs relating to the financing of land on which a qualifying asset is constructed, may also be capitalised.

## Findings

**Chart 7: Borrowing costs on land**



Fifty-six percent (56%) of participants were of the opinion that borrowing costs incurred on the land on which a qualifying asset (e.g. a building) is constructed, can be capitalised. The reasoning was that the land is necessary to bring the asset to completion. The existence of the asset constructed depends on the land. However, 44% of participants felt that land does not meet the definition of a qualifying asset, and therefore that capitalisation should not occur. These two assets, that is, land and buildings, are two separate assets, of which only one satisfies the definition of a qualifying asset; therefore IAS 23 does not apply to the land.

## 5. Conclusion, implications and recommendations

From the research findings it is clear that participants were somewhat divided on the issue of what constitutes a substantial period of time in deciding whether an asset is a qualifying asset or not. The vast majority of participants (89%) were torn between a period of more than 6 months and more than 1 year. The point was also raised that it might not be appropriate at all to try and determine the length of time that should be associated with the definition of a qualifying asset, and that allowing for judgement is in fact a positive feature and not meant to cause confusion.

The majority of participating academics were of the opinion that wine would qualify for the scope exclusion in IAS 23. It is however worth noting that, based on the wording of paragraph 4 of IAS 23 (International Accounting Standards Board, 2009:1428), this scope exclusion is not mandatory, so that winemakers may still choose to apply the capitalisation approach of IAS 23.

In respect of the period of time that will constitute an “extended” period during which the active development of a qualifying asset is suspended, the majority of participants felt that more than three months is appropriate, although some participants felt that a longer period of more than six months is more adequate.

Although a larger asset is created when capitalisation does not cease during an avoidable delay, it would appear that avoidability does not play a role in the suspension decision from the viewpoint of the vast majority of participants, and that only commonality should be taken into consideration. Some compelling arguments were raised both in favour of suspension being fair, as well as against its being fair, in the case of an uncommon event being unavoidable.

The word “uncommon”, which is used within IAS 23 as an example of application, generally did not carry sufficient weight to persuade the participants to expense finance costs on the financing of additional work caused by an uncommon event. Furthermore, most participants regarded a common event as not always being a necessary part of the production process. When considering which factor to use when deciding on suspension, a helpful point of view might be to investigate whether the event is a direct part of the production process and if it is controllable by management (a point raised by one of the participants and also supported in the literature; refer to section 2.2). However, less than half of the participants favoured the non-suspension of the capitalisation of borrowing costs upon the occurrence of circumstances not under management’s control, which was the subject of a specific question in the questionnaire.

According to the majority of participants in this study, compounded interest (as opposed to simple interest) should be capitalised even if activities only commence after an initial period in which financing was obtained but activities have not yet started. Furthermore, the suspension of capitalisation will probably not reduce the compounded interest component of the amount of borrowing cost to be capitalised for a specific loan, as deduced from the majority response obtained from the participants.

The majority of participants further believed that a qualifying asset possessing different parts/components should not cause the apportioning of capitalised borrowing costs between completed and uncompleted parts, and that capitalisation should be continued during the period of assembly of the different parts into one qualifying asset. Moreover, IAS 38 does affect the IAS 23 calculation in respect of the amount of borrowing costs to be capitalised. This in itself might not be as complicated, but once compounding of interest is also introduced, this calculation might become

challenging. In practice exact details and calculations of prior periods will need to be retained by accountants in order to enable the correct calculation of the amount to be capitalised each year.

Based on the majority response, even though land itself is not a qualifying asset, it is necessary to bring another asset (e.g. buildings) to completion, and therefore the borrowing costs incurred on such land should also be capitalised.

From the findings of this study it became clear that, even though in some instances there was a distinct majority leaning towards a specific interpretation of the principles of IAS 23, there were also many instances where the participants were strongly divided in their views. This inevitably leads one to question the comparability of financial statements in practice, if accountants with arguably the greatest technical expertise cannot even agree on the correct accounting treatment for borrowing costs.

The cases where participants were divided in their opinions prove that there are in fact many uncertainties in the technical application of IAS 23. Further, because the standard leaves much open for interpretation and does not always give clear guidance, calculating the correct answer may be extremely difficult. The findings of this research could prompt standards-setters to provide clearer guidance for the revision of future standards on borrowing costs in various different accounting frameworks, or even the rethinking of other standards with similar uncertainties, especially if this study is supplemented by further research in the same area in future. However, participants were not as divided in all areas; hence the findings in this research could be used, to some extent, as guidance regarding the correct accounting treatment for various scenarios. This could be useful to, amongst others, accountants in practice, auditors, authors of text books and guidance documents, university lecturers and providers of continuing professional development (CPD) training.

It is therefore recommended, based on the results of this study, that standards-setting bodies provide clearer guidance on areas which clearly are technically uncertain, and that financial statement preparers and users look toward this research when seeking answers to technically challenging questions.

## **6. Limitations**

The study was of such a nature that a scale could not be used for selecting an appropriate answer to each of the questions. The questions were asked in such a manner that a definite answer needed to be selected (see Appendix A). The data was therefore not analysed using a statistical package but rather by using electronic spreadsheet software. Information gathered during this study could also

not be extrapolated to the entire population since the participants did not represent a random sample. Furthermore, responding to the questions was quite complex and time consuming since participants would have had to calculate the answers based on the principles of IAS 23. This might have contributed to a lower number of respondents.

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## APPENDIX A: TECHNICAL QUESTIONS IN THE QUESTIONNAIRE

1. According to IAS 23, the definition of a qualifying asset is: “An asset that necessarily takes a substantial period of time to get ready for its intended use or sale”.

What would you regard as a substantial period of time in most circumstances? Please choose one option below.

3 months or less	More than 3 months up to 6 months	More than 6 months up to 12 months	More than 1 year up to 2 years	More than 2 years up to 3 years	3 years or more

2. The scope of IAS 23 excludes inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

In your opinion, does wine (which is inventory) generally qualify for this scope exclusion?

Yes	No

Please briefly motivate your answer as above (please type in the box):

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3. According to IAS 23, an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

What do you regard as an extended period in this context? Please choose one option below. If you are of the opinion that one cannot generalise in this way, please choose the one option that you feel will hold true in most circumstances and for most entities.

3 months or less	More than 3 months up to 6 months	More than 6 months up to 12 months	More than 1 year up to 2 years	More than 2 years up to 3 years	3 years or more

**For questions 4 to 9, please read IAS 23 paragraph 20 – 21.**

4. Assume the following scenario: high water levels which are “**common**” for the specific time of year cause a delay in the construction of a bridge for an extended period of time, **even though the delay could have been knowingly avoided if construction took place at a different time of the year**. Should capitalisation of borrowing costs be suspended or not?

Suspend	Do not suspend

5. According to the example in IAS 23.21, a substantial delay caused by an **uncommon** event would cause capitalisation of borrowing costs to be suspended. Assume that there are two identical companies, building two identical bridges at two different locations. Company A

builds its bridge at a location where high water levels are common, and therefore during the period of the delay the company is allowed to capitalise borrowing costs. Company B builds its bridge where high water levels have never occurred in the past, but during the building process high water levels cause delays in the construction of the bridge. By following the guidance of IAS 23, Company B should not capitalise borrowing costs during the period of the delay. Do you believe that this is fair?

Yes	No

Please briefly motivate your answer as above (please type in the box):

6. If an **uncommon** event leads to additional work being required on the development of a qualifying asset, and such additional work also needs to be financed, should borrowing costs on the financing of such additional work be capitalised?

Yes	No

Please briefly motivate your answer as above (please type in the box):

7. In your opinion, is any “**common**” event (i.e. an event which is a general and natural part of the process in given circumstances) **always** a necessary part of the process of getting the asset ready for its intended use or sale? (For example when a strike by employees in South Africa is regarded as a common event because strikes often occur in the particular industry.)

Yes	No

8. If circumstances leading to the suspension of activities for an extended period of time are **not under the control of management**, should capitalisation be suspended?

Yes	No

9. If the construction of an asset is delayed for an extended period of time because of the untimely death of the engineer in charge, is this a necessary/common part of the process, and is capitalisation of borrowing costs therefore continued?

Yes	No

10. A loan of R100 000 is incurred **specifically** to finance a qualifying asset. Interest is charged at 10% per annum and capitalised to the loan at the end of each year. Activities have been undertaken from the start of the first year to prepare the asset for its intended use or sale. In the first year R10 000 interest is incurred on the specific loan. However, the R100 000 capital is not yet used during the first year to prepare the asset for its intended use or sale (e.g. other

funds are used for this purpose in the first year). Should this R10 000 interest be capitalised to the qualifying asset?

Yes	No

11. A loan of R100 000 is incurred **specifically** to finance a qualifying asset. Interest is charged at 10% per annum and capitalised to the loan at the end of each year. Interest of R11 000 (R110 000 x 10%, i.e. compound interest) is incurred in the second year of the loan. Activities have been undertaken from the start of the **second** year to prepare the asset for its intended use or sale. Should the R11 000 be capitalised, or only R10 000, or a different amount?

R 11 000	R 10 000	Different amount

If you chose “different amount” please state the amount and reason as well as the calculation (please type in the box):

12. Expenditure of R100 000 is incurred on a qualifying asset. A **specific** loan is used to finance the expenditure and interest is charged at 10% per annum (compounded annually). In the first year a total of R10 000 interest is incurred. An unexpected event necessitates the suspension of the capitalisation of borrowing costs for 5 months during the first year. After this 5 month period, activities continued as usual. This scenario would lead to the capitalisation of only R5 833 of borrowing costs for the first year ( $R10\ 000 \times 7/12$ ). During the second year, interest of R11 000 is incurred. The amount of borrowing costs to be capitalised for the **second** year is:

R11 000	R10 583 [(100 000 + 5 833) x 10%]	R10 000	Different amount

If you chose “different amount” please state the amount and reason as well as the calculation (please type in the box):

13. A **specific** R2 000 000 loan bearing **simple** interest at 10% per annum is incurred to pay for the rental expense of a large warehouse. The warehouse is used to manufacture and assemble a machine consisting of 5 very large separate parts (all 5 parts are also manufactured in the warehouse before assembly of the machine). The company will not need to apply componentisation on the machine for depreciation purposes, seeing that the useful lives of the 5 parts are all equal. The machine is a qualifying asset and borrowing costs incurred should be capitalised. The manufacturing of all 5 parts started at the beginning of the first year. The manufacturing of parts 1 and 2 is completed at the end of the second year. Parts 3 and 4 are completed at the end of the third year and part 5 at the end of the fourth year. It takes another 2 months at the beginning of the fifth year to assemble the 5 parts into one machine.

Assume that the interest is paid in cash at the end of every month. In years 1 and 2, interest of R200 000 will be capitalised. What amount will be capitalised for years 3 to 5?

**Year 3:**

R200 000 (2 000 000 x 10%)	R120 000 (2 000 000 x 10% / 5 x 3 parts)	Different amount

If you chose “different amount”, please state the amount and provide a reason and calculations (please type in the box):

--

**Year 4:**

R200 000 (2 000 000 x 10%)	R40 000 (2 000 000 x 10% / 5 x 1 parts)	Different amount

If you chose “different amount”, please state the amount and provide a reason and calculations (please type in the box):

--

**Year 5:**

R200 000 (2 000 000 x 10%)	R0	R33 333 (2 000 000 x 10% / 12 x 2 months)	Different amount

If you chose “different amount”, please state the amount and provide a reason and calculations (please type in the box):

--

14. On 1 January 2009, an entity borrows R1 000 000 (**specific** loan) from a bank at an interest rate of 10% per annum (compounded annually) to finance the research **and** development of an internally generated intangible asset. The capital and interest will only be paid back at the end of 3 years. The research phase starts on 1 January 2009. Research costs amount to R300 000 and the research phase is completed on 31 March 2009. On 1 April 2009 the development phase starts (assume that all requirements for the recognition of development costs of IAS 38 are met on this date) and is completed on 31 March 2011. The total development costs amount to R700 000 for the full development phase. The amounts of borrowing costs to be capitalised for the years ended 31 December 2009 and 31 December 2010 are:

**31 December 2009:**

R 100 000 (calc. 1)	R 30 000 (calc. 2)	R 75 000 (calc. 3)	R 70 000 (calc. 4)	R 52 500 (calc. 5)	Different amount

Calculation 1 = 1 000 000 x 10%

Calculation 2 = 300 000 x 10%

Calculation 3 = 1 000 000 x 10% / 12 x 9 months

Calculation 4 = 700 000 x 10%

Calculation 5 = 700 000 x 10% / 12 x 9 months

If you chose “different amount”, please state the amount and provide a reason and calculations (please type in the box):

--

**31 December 2010:**

R 100 000 (calc. 6)	R 70 000 (calc. 7)	R 110 000 (calc. 8)	R77 000 (calc. 9)	R 107 000 (calc. 10)	Different amount

Calculation 6 = 1 000 000 x 10%

Calculation 7 = 700 000 x 10%

Calculation 8 = (1 000 000 + 100 000) x 10%

Calculation 9 = (700 000 + 70 000) x 10%

Calculation 10 = (1 000 000 + 70 000) x 10%

If you chose “different amount”, please state the amount and provide a reason and calculations (please type in the box):

--

15. If vacant land is purchased for the purpose of constructing a qualifying asset on this land, and both the qualifying asset to be constructed and the purchased land are financed by one specific loan, may borrowing costs be capitalised on the **land** on which the asset is constructed?

Yes	No

Please briefly motivate your answer as above (please type in the box):

--

## *Chapter 4*

### *Summary, conclusion and recommendations*

## **1. Introduction**

This study has endeavoured to investigate both the practical implications and technical uncertainties surrounding the revised IAS 23, the standard on borrowing costs. Questionnaires completed by accounting professionals from companies listed on the JSE were used in testing the hypothesis that the revision causes significant practical difficulties for companies in South Africa. Financial accounting academics were targeted to examine the hypothesis that owing to the fact that the theory of the standard (IAS 23) remained relatively untested in practice, there may be various grey areas relating to certain technical issues in the revised standard, which entities in practice may find challenging to apply.

As was discussed in chapter 1, the revision of IAS 23 was met with a great deal of resistance. Reasons for the unhappiness included the cost versus the benefit of revising the standard as well as the issue that accountants felt that they needed more guidance relating to the application of certain technical uncertainties within IAS 23.

However, when delving deeper into exactly why accountants felt negative towards the revision of IAS 23, another possibility for the adverse reaction became evident in the current study. It is possible that the negative reaction resulted from a slightly negative attitude that accountants felt towards the revision of IAS 23. This becomes evident in that accountants with experience relating to the application of the revised IAS 23 tended to be less negative towards it, and also felt that it was less costly and less difficult to apply, while their colleagues tended to believe otherwise, possibly because they possessed less experience with the application of IAS 23.

## **2. Overview of research method used**

A review of the literature laid the foundation for the empirical study which was performed, by identifying possible practical and technical obstacles that accountants may encounter regarding the application of the revised IAS 23.

Part 1 of the empirical study, which addressed the practical issues, was designed in the form of an empirical survey: hence the study followed a largely quantitative methodological paradigm (Davies, 2007:188). Part 2, which dealt with the technical uncertainties, also largely followed such a paradigm since the research design was in the form of an empirical survey (Davies, 2007:188).

Questionnaires were prepared based on information gathered during the literature review and were e-mailed to the participants. After receiving the completed questionnaires, the data was analysed by using either electronic spreadsheet software or the statistical software package SPSS (SPSS, 2008); whichever was applicable.

### **3. Summary of research results**

#### **3.1. Practical difficulties**

Before the IASB officially revised IAS 23, discussions and meetings were held and comment letters were obtained relating to the suggested changes. From these a few arguments were advanced against revising IAS 23. One such argument was that the cost relating to the implementation of the capitalisation model could be significant (International Accounting Standards Board, 2006).

From the study it was found that participants believed that the mandatory capitalisation of borrowing costs is more costly than not. Examples of such costs are training, a new information system, a modified internal control system and accounting expenses. Of the said costs, training appeared to be the biggest factor leading to increased costs. Participants also felt that the IASB did not adequately consider the cost implications in its decision to change IAS 23 and that the benefits obtained from the capitalisation of borrowing costs are not that noticeable in practice.

According to Grant Thornton (2006), the mandatory capitalisation of borrowing costs will increase cost and complexities. The South African Institute of Chartered Accountants (2006) asked for specific guidance on certain aspects of IAS 23 and PricewaterhouseCoopers (2006) noted that it would be helpful if further guidance could be provided. One could deduce from these comments that the application of IAS 23 might be difficult.

From the study it can be concluded that participants agreed that they find the application of IAS 23 fairly difficult, especially when intra-group financing and consolidations are involved. When internally generated intangible assets or foreign currency loans are added to the mix, participants agreed that its application becomes still more difficult. Training may therefore be needed owing to the complexity of the requirements of IAS 23.

Raghavan (2009:14) stated that convergence efforts have experienced slower than anticipated progress. One reason for this is that rules-based standards provide a form of safety, so that accountants and auditors have been reluctant to move away from this. Cultural diversity relating to differences in styles and wording of standards may also be slowing the process down (Raghavan,

2009:14). The word 'reluctant' may indicate that the cause of the objections to the mandatory capitalisation of borrowing costs might be linked to the attitudes of professional accountants and auditors.

The attitudes of practitioners tended to lean slightly more to being negative towards the new IAS 23, rather than positive. This somewhat unenthusiastic attitude could influence the opinions of practitioners into feeling that the new IAS 23 is both costly and difficult to apply. Also, the more difficult the application, the more costly it would be.

Participants whose companies did not possess qualifying assets appeared to think that mandatory capitalisation is more costly and more difficult and exhibited a more negative attitude towards it than participants whose firms did possess qualifying assets. This might indicate that participants who possessed experience of the application of capitalisation tended to realise that this technique is not that difficult or costly to apply, and as a result their attitude towards it was also less negative. It therefore appears that the preconceived ideas of participants who had not physically dealt with capitalisation, might not be entirely valid.

It is also noteworthy that differences in business sectors did not materially affect the answers of participants, indicating that participants from various business sectors hold similar opinions and that the application of IAS 23 does not necessarily affect some more than others.

The attitude of participants with more than 10 years of experience seems to have been more negative towards the now mandatory capitalisation of borrowing costs, compared to that amongst participants with less than 10 years of experience.

Differences between US GAAP and IFRS appeared not to promote comparability, but were thought to cause confusion, be burdensome and complex, and lead to additional accounting work. Therefore, the mandatory capitalisation may lead to uniformity, but not comparability, of financial statements.

### **3.2. Technical uncertainties**

Because the application of IAS 23 is dependent upon definitions and the interpretation of these definitions as well as guidance, questions were asked about how a variety of knowledgeable accounting academics would understand and apply some of the definitions and guidance within

IAS 23. The results were mixed. In some instances there were definite divides between participants whereas in others, opinions were quite similar.

Areas where a divide was identified included the interpretation of a substantial period of time (in respect of the definition of a qualifying asset) and an extended period of time (in respect of the suspension decision), as well as a lack of clarity regarding the guidance with respect to the definition of a common/uncommon event. Participants were also divided in their feeling towards the fairness of the capitalisation of borrowing costs being dependent on whether an event is common or not, and also in their opinions on whether capitalisation should be suspended or not, under circumstances beyond the control of management. It also seemed that participants were not entirely clear as to whether borrowing costs may be capitalised on vacant land purchased for the purpose of constructing a qualifying asset if this is financed together with the related qualifying asset being constructed.

There were, however, also some areas where participants were largely in agreement. The avoidability of an event did not influence the majority of participants' opinions on whether to suspend capitalisation or not. It was also found that the word 'common', which is used within IAS 23 as an example for application, generally did not carry sufficient weight to persuade the participants to expense finance costs on additional work caused by an uncommon event.

Two guidelines given within IAS 23 suggest that, firstly, if an event is common, suspension of the capitalisation of borrowing costs will not take place, and secondly, that a temporary delay which is a necessary part of the process will not lead to suspension. In other words, this could be interpreted that the occurrence of a common event, which is also an event that is a necessary part of the process, will not lead to suspension. When asked whether participants viewed any common event as always being a necessary part of the production/construction process, the majority yielded a negative response. This might indicate that some doubts may arise regarding which one of the two factors (commonality vs. necessity) will be preferred in deciding whether or not to suspend capitalisation of borrowing costs. Therefore, even though the participating academics were largely in agreement, this technical uncertainty remains.

Participants also mostly agreed on the following: where a specific loan is incurred to finance a qualifying asset, but this loan is not yet utilised for the initial period in which activities are undertaken (so that other funds are instead used for this purpose during this initial period, but interest is already accruing on the specific loan), that the interest on the specific loan relating to this initial period should be capitalised. In this scenario, investment income will reduce the amount of

borrowing costs allowed for capitalisation and therefore borrowing costs will not be ‘over’ capitalised.

When faced with a scenario where compounded interest is applicable over a construction period of two to three years, and activities have only been undertaken in the second year, academics mainly agreed that the compounded interest for the second year should be capitalised, and not only the simple interest relating to the second year. Furthermore, it was also clear from the majority response that suspension of capitalisation for a short period within a year should not influence the compounding of interest. In other words, it will not reduce the compounded interest component of the amount of borrowing cost to be capitalised for a specific loan. Another mostly unanimous answer obtained was that a qualifying asset possessing different parts/components should not cause the proportioning of capitalised borrowing costs, and that capitalisation should be continued during assembly of the different parts into one qualifying asset, thus eliminating a further possible grey area.

Participants also largely agreed that IAS 38 relating to internally generated intangible assets affects the IAS 23 calculation in respect of the amount of borrowing costs to be capitalised. When compounding of interest was added to the scenario of internally generated intangible assets, participants were, however, more divided in their opinions, indicating that such a scenario may be challenging to account for and may result in inconsistent accounting in practice.

#### **4. Recommendations**

Based on the results of part 1 of this study, it is recommended that IAS 23, as the standard for borrowing costs, be revised by standard-setting bodies in order to address practical difficulties and inefficiencies. The ideal solutions would be, firstly, for the IASB to explore in depth both the expensing of borrowing costs as well as the capitalisation thereof, secondly, decide the most appropriate approach and, thirdly, bring IAS 23 and SFAS 34 directly in line with each other as this was the main reason for the revision of IAS 23 in the first place. As part of this process, it is recommended that the IASB attempts to eliminate practical difficulties in the application of the standard as far as possible. In doing so, it will be more likely that the cost of application will not outweigh the benefits obtained. Moreover, a free choice between capitalisation and the income statement approach may allow for more useful accounting information depending on the needs of the specific financial statement users and other stakeholders.

Based on the results of part 2 of the study, it is recommended that standard-setting bodies provide clearer guidance on areas which are clearly technically uncertain, and that financial statement preparers and users should look toward this research when seeking answers to technically challenging questions. The principles contained in the standard are well thought through and even though it might appear not to be so, there is usually ‘method in the madness’ even in light of a lack of clearer guidance.

## 5. Concluding reflection

From the study it appears that there are practical difficulties with the application of IAS 23 and that applying the revised IAS 23 appears to be more costly than not. The difficulty of applying IAS 23 appears to be a motivator for the slightly negative attitude of participants towards mandatory capitalisation. However, it is also quite possible that this somewhat unenthusiastic attitude might be caused by the cost implications of IAS 23. It should also be noted that participants might find the application of IAS 23 difficult because of their rather negative feelings, especially when taking into account that those with experience in capitalisation, actually found it less costly and less difficult. Therefore it can be concluded that cost, difficulty as well as attitude, play a role in how participants perceive the revision of IAS 23 and even though there might be practical difficulties in applying IAS 23, accountants and auditors who embrace the change might find that these difficulties are easier to overcome than expected.

Overall, it does appear from the study that there might be fewer grey areas in IAS 23 than originally anticipated. This is a good indication that the IASB passes new standards only after careful consideration of their impact. However, the numerous instances where participating academics were in disagreement, indicate that there is in fact a fair amount of technical uncertainty for which clearer guidance may in all probability be needed. In recent times, it appears that the IASB has concentrated most of its efforts into expanding guidance in standards that are regarded as complex. However, this study provided evidence that a ‘simple’ standard like IAS 23 may not be as simple after all, and that a detailed guideline (perhaps with illustrative examples in the standard) may be warranted.

## 6. Addressing the research goals

The research goals of the study were addressed as follows:

**Objective:** To determine whether accountants in practice perceive the mandatory capitalisation of borrowing costs as a **costly** exercise.

**Addressed:** Various questions relating to the cost of the application of IAS 23 were asked within the questionnaire sent to the JSE companies. It was found that it was perceived as being more costly than not.

**Objective:** To determine whether accountants in practice find the capitalisation of borrowing costs to be **difficult** to apply.

**Addressed:** Various questions relating to the difficulty of the application of IAS 23, were asked within the questionnaire sent to the JSE companies. It was found that participants experienced the application of IAS 23 as being fairly difficult in practice.

**Objective:** To assess the **attitude** of accountants in practice towards the now mandatory capitalisation of borrowing costs.

**Addressed:** Various questions relating to the attitude of accountants relating to capitalisation of borrowing costs, were asked within the questionnaire sent to the JSE companies. It was found that participants' attitudes were slightly negative.

**Objective:** To evaluate the opinions of accountants in practice regarding certain aspects of the **accuracy and usefulness** of the capitalisation of borrowing costs, including inconsistencies between the revised IAS 23 and the corresponding US GAAP standard.

**Addressed:** Various questions relating to the accuracy and usefulness of capitalisation of borrowing costs, were asked within the questionnaire sent to the JSE companies. It was found that, overall, participants felt that capitalisation does lead to accurate accounting, but that it might not be as useful.

**Objective:** To identify any possible **correlations** between accountants' opinions on cost effectiveness, difficulty, attitude and accuracy regarding the capitalisation of borrowing costs.

**Addressed:** By using Pearson's product-moment correlation coefficient, the relationships between the components in the questionnaire were investigated. It was found that there was a strong positive correlation between difficulty and cost, between attitude and cost and between attitude and difficulty.

**Objective:** To **compare** the opinions of different demographic groups of accountants in practice on cost effectiveness, difficulty, attitude and accuracy of the capitalisation of borrowing costs.

**Addressed:** The above objective was achieved by comparing the means between different demographic groups within the sample of this research study. The highlight of the findings, was that

the attitude of participants with more than ten years of experience appears to have been more negative towards the now mandatory capitalisation of borrowing costs compared with the attitude of participants with less than ten years of experience. Participants who did not possess qualifying assets appeared to think that mandatory capitalisation is more costly, more difficult and held a more negative attitude towards capitalisation than the participants who did possess qualifying assets, and lastly, there were no large or medium effect sizes identified between any of the different business sectors.

**Objective:** To gain the opinions of South African accounting academics relating to the technical uncertainties with the application of the requirements of the revised IAS 23.

**Addressed:** The questionnaire that was prepared contained questions aimed at obtaining the opinions of South African accounting academics relating to the application of the requirements of IAS 23. The questionnaires that were received back, were then summarised in a spreadsheet so as to enable the researcher to collectively identify the opinions of South African academics.

**Objective:** To suggest the most appropriate accounting treatment of the technical uncertainties identified.

**Addressed:** Based on the summary of the opinions of the South African academics, conclusions were drawn for each question based on the tendency of the majority's responses.

## **7. Limitations of this study**

Limitations relating to part 1 of the empirical study include the fact that only 36 listed companies participated in the study. The sample was not selected randomly (it was a convenience sample) and therefore the results could not be extrapolated over the entire population by way of inferential statistics. Therefore, conclusions drawn from the sample of participants cannot be generalised to the population of all listed companies in South Africa. The questionnaire consisted of 40 questions and was therefore quite long.

Limitations of part 2 of the empirical study included the fact that the study was of such a nature that a Likert scale could not be used in answering the questions, which therefore only allowed for limited statistical analysis. The questions were asked in such a manner that a definite answer needed to be chosen. Therefore the data was not analysed using a statistical package, but rather by using an electronic spreadsheet. Moreover, the questions asked were fairly complex and time consuming to

answer because participants would have had to calculate the answers and perhaps even refer to guidance in the standard. This might have reduced the number of responses ultimately obtained.

## **8. Areas for future research**

Apart from expanding the research conducted in this study, further areas of study could include investigating the broader field of the IASB convergence projects. This could be conducted for individual IASB projects or a collective study might be undertaken on the impact of these convergences and whether they have the positive effect that is desired. Another possibility is to examine the differences between IFRS and US GAAP and the detailed impacts of these differences on financial statements and decision-making.

Researching the suggestions made by respondents in the comment letters to the IASB might also prove beneficial. One such example was the suggestion that an economic interest rate should be used when calculating the amount of borrowing costs to be capitalised.

Relating to the technical uncertainties, it might be advantageous to investigate group structured financing and borrowing costs, as quite a few comments were made by respondents in the comment letters to the IASB regarding the need for specific guidance within IAS 23 relating to this type of financing. An in-depth investigation into the application of general loans is also an area to be considered.

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## Annexure A – Capitalisation of Borrowing costs: Practical difficulties and cost versus benefit – Questionnaire

You are kindly requested to mark the option that describes your opinion of the question the most with a cross (X), unless otherwise stated.

### Part A: Demographic placement

	Yes	No
1 Are you a member of a professional accountancy body?		

2. If you answered "yes" to the previous question, which professional body or bodies are you a member of?	
a) Association of Certified Chartered Accountants (ACCA)	
b) Chartered Institute of Management Accountants (CIMA)	
c) Independent Regulatory Board of Auditors (IRBA)	
d) Institute of Internal Auditors (IIA)	
e) Institute of Municipal Financial Officers (IMFO)	
f) South African Institute of Chartered Accountants (SAICA)	
g) South African Institute of Professional Accountants (SAIPA)	
h) Southern African Institute of Government Auditors (SAIGA)	
i) Other: please specify .....	

3. What is the name of the company that you work for?	
4. How many years have you been a member of a professional accountancy body?	
5. How many years have you been working as an accountant (or similar position) at the current company?	
6. In which business sector does the company function (e.g. mining, retail, etc.)?	

	Yes	No	N/A
7. Your company complies with International Financial Reporting Standards (IFRS/SA GAAP).			
8. Your company does have qualifying assets as defined in the revised IAS 23 (being an IFRS/SA GAAP standard). Refer to the letter on page 2 for the definition.			
9. Your company already had the policy to capitalise borrowing costs on qualifying assets, even before IAS 23 was revised to require the mandatory capitalisation of such borrowing costs, and was actively applying this policy because the company had qualifying assets.			
10. Even though your company has qualifying assets, in the past the company chose not to capitalise borrowing costs on these assets (as was allowed under the previous version of IAS 23).			
11. The requirement of the revised IAS 23 to capitalise borrowing costs on qualifying assets is not relevant to your company now, but may become relevant in the foreseeable future.			
12. Your company reconciles its financial statements to United States Generally Accepted Accounting Principles (US GAAP).			

## **Part B: Practicality of capitalising borrowing costs on qualifying assets**

**Important: If your company has qualifying assets, please answer the questions below on behalf of your company. If the new requirements of IAS 23 do not affect your company because it does not have qualifying assets or it does not comply with IFRS, please answer the questions below from a general perspective as an accountant, i.e. give your opinion regarding the consequences of the mandatory capitalisation of borrowing costs if relevant to a specific company, even though it is not relevant to your company.**

**If your company has already voluntarily capitalised borrowing costs in the past, please answer the questions below accordingly (e.g. question 2 below: if your company’s information system was already adequate due to the fact that your company already capitalised borrowing costs in the past, please answer “4” to this question).**

**Legend:**

Answer the following questions where:

1. You strongly disagree
2. You disagree
3. You agree
4. You strongly agree

<b>Questions</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>
1. The mandatory capitalisation of borrowing costs leads to complicated accounting for construction contracts.				
2. In my opinion there are other standards that had a greater need to be updated and converged.				
3. Capitalisation of borrowing costs on intra-group financing complicates the consolidation process due to, amongst others, the recalculation of weighted average capitalisation rates.				
4. In your opinion, the International Accounting Standards Board (IASB) adequately considered the cost implications when they revised the standard on borrowing costs (IAS 23).				
5. The capitalisation of borrowing costs leads to more accurate accounting.				
6. The new or upgraded information system necessitated by the mandatory capitalisation of borrowing costs needs to be monitored over a period, leading to costly increased accounting work.				
7. In my opinion, the previous version of IAS 23 worked well and there was no need for this irritable change.				
8. The mandatory capitalisation of borrowing costs lead to uniformity, but not comparability of financial statements.				
9. Because a weighted average interest rate is used to calculate the amount of borrowing costs to be capitalised when general borrowings are used, the capitalisation of borrowing costs is not that accurate.				
10. For companies who reconcile IFRS/SA GAAP and US GAAP financial statements, the burden of keeping two sets of information on borrowing costs adds to the complexity in complying with the new IAS 23.				
11. Seeing that capitalised borrowing costs are not reflected in profits, the company’s profit will be higher and thus more truthfully measured.				

12. If a company using IFRS for accounting is a subsidiary of a company using US GAAP, and this company has borrowing costs that need to be capitalised, it would have to keep 2 sets of records, for consolidation purposes, because of the differences between IFRS and US GAAP. This proves that the revision of IAS 23 does not promote comparability and therefore has no purpose.				
13. Seeing that most credit analysts write back capitalised borrowing costs, the mandatory capitalisation of borrowing costs is not very useful.				
14. The benefits obtained from the mandatory capitalisation of borrowing costs is noticeable in practice.				
15. In your opinion, the capitalisation of borrowing costs leads to a challenging measurement process.				
16. Users of financial statements prefer the inclusion of capitalised borrowing costs in earnings when earnings per share is calculated and disclosed.				
17. Using an economic interest cost (applying a current market risk-adjusted rate of return for capitalisation) will lead to more accurate information than the current capitalisation method required by the revised IAS 23.				
18. I am all for the mandatory capitalisation of borrowing costs.				
19. Due to the mandatory capitalisation of borrowing costs, a modified internal control system is needed, taking up additional management time and it might lead to incremental audit fees.				
20. I feel that the now mandatory capitalisation of borrowing costs is a mess.				
21. I believe that accountants, including myself, will implement the mandatory capitalisation of borrowing costs because they have to and not because they want to (if the company they are working for has qualifying assets).				
22. I feel that the IASB went over the top by changing the standard on capitalisation of borrowing costs.				
23. In my opinion the capitalisation or non-capitalisation of borrowing costs does not have a material effect on accounting costs or professional fees incurred by the company.				
24. In your opinion, the mandatory capitalisation of borrowing costs on qualifying assets leads to increased accounting expenses for a company.				
25. The new requirement of the mandatory capitalisation of borrowing costs has a negligible impact on the company's costs to produce the required information.				
26. I feel that the change to mandatory capitalisation of borrowing costs is an unnecessary hassle to the company.				
27. The requirement of the mandatory capitalisation of borrowing costs is easy to apply.				
28. The mandatory capitalisation of borrowing costs complicates the accounting for internally generated intangible assets (like research and development).				
29. The mandatory capitalisation of borrowing costs does not increase the difficulty of accounting for foreign currency loans used to finance the construction of qualifying assets.				
30. The allocation of capitalised borrowing cost to the separately identified parts/components of an asset is not difficult, or not necessary.				
31. I am not opposed to the change in IAS 23 from selective to mandatory capitalisation of borrowing costs.				

32. The capitalisation of borrowing costs leads to higher administrative expenses.				
33. For a company that reconciles its financial statements to United States Generally Accepted Accounting Principles (US GAAP), the revised IAS 23 now leads to additional accounting work and/or audit fees.				
34. The mandatory capitalisation of borrowing costs can lead to an insolvent company appearing solvent, as assets could still exceed liabilities because of the capitalised borrowing costs.				
35. In your opinion, a company's accountants need training/ guidance regarding the capitalisation of borrowing costs, bringing about an increase in training expenses.				
36. The changes that need to be made to the information system (due to the mandatory capitalisation of borrowing costs) are either not very costly, or no changes are needed.				
37. The differences between IFRS/SA GAAP and US GAAP in calculating capitalised borrowing costs cause confusion and adds to the difficulty of the calculation.				
38. The South African Institute for Chartered Accountants (SAICA) and the Accounting Practice Board (APB) should have done more to prevent the capitalisation of borrowing costs becoming mandatory.				
39. It is necessary to provide training to the accountants of a company due to the complexity of the now mandatory capitalisation of borrowing costs on qualifying assets.				
40. Because only partial convergence exists between IFRS/SA GAAP and US GAAP regarding borrowing costs, the change is only temporary and therefore the revision of IAS 23 is only an annoyance.				

Please feel free to write down any opinion or feeling you might have on the capitalisation of borrowing cost, which was not mentioned in the above questionnaire. Any and all comments given will be much appreciated.

Comments

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	Yes	No
Would you like to receive a report of the research findings?		

## **Annexure B – Capitalisation of Borrowing costs: An investigation into technical uncertainties in IAS 23 – Questionnaire**

Refer to Appendix A: Technical questions in the questionnaire, at the end of chapter 3 on page 75.

This questionnaire was submitted as an appendix at the end of the relevant article.

## Annexure C.1 – Submission confirmation: Meditari

----- Forwarded message -----

From: Louise <[louise@icon.co.za](mailto:louise@icon.co.za)>

Date: Thu, Nov 4, 2010 at 10:21 AM

Subject: Meditari art 25.10

To: [leanivanstaden@gmail.com](mailto:leanivanstaden@gmail.com)



Department of Accounting  
University of Pretoria  
Pretoria, 0002

[elmar.venter@up.ac.za](mailto:elmar.venter@up.ac.za)

4 November 2010

Dear Ms L van Staden

**Re: Capitalisation of borrowing costs: Practical difficulties and cost versus benefit**

This letter formally acknowledges the receipt of your article which you submitted to *Meditari Accountancy Research* for consideration.

Your article will be preliminary considered by one of the Associate Editors and we will correspond with you regarding the suitability of the article for publication in *Meditari Accountancy Research*.

Yours sincerely

**Prof E Venter**

**Editor: Meditari**

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## Annexure C.2 – Submission confirmation: SAJAR



**From:** Maureen Lawrence [<mailto:Maureen.Lawrence@uct.ac.za>]

**Sent:** 05 November 2010 14:24

**To:** Van Staden, Leani

**Subject:** SAJAR submission Ref 10/22

Dear Leani

Prof Uliana has asked me to acknowledge with thanks your submission to SAJAR. It has been entered into the review process and he will be in touch with you again once the reports are received from the reviewers.

Unfortunately this is a very difficult time of year to find people who are willing to review and the reports may only be received early next year.

With kind regards

Maureen

Maureen Lawrence

PA to Prof Enrico Uliana

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## **Annexure D.1 – Author guidelines: Meditari**

### **Editorial requirements**

*Meditari Accountancy Research* is a research journal that originated at the Department of Accounting of the University of Pretoria.

Research articles of a high standard from all authors are welcome. The readership of the journal are people with an interest in research in the field of Accountancy and related subjects, including Accountancy Education. To make a contribution, an article should clearly indicate what theory/theories underpin the research in order to position the article appropriately within the Accounting research arena. In addition, a literature review in the article should indicate how the article will contribute to the existing literature.

Since 2004, *Meditari Accountancy Research* has appeared twice per year.

### **Presentation**

Manuscripts submitted for consideration should

- be typed in MS Word;
- be typed in double spacing on one side of A4 paper, using Arial or Times New Roman, font size 12;
- be not longer than 25 pages;
- be paginated;
- have a cover sheet stating the title of the article, the name(s) of the author(s), their academic status and acknowledgements of financial and other assistance (where applicable), as well as the author's/authors' telephone number(s), postal address(es) and email address(es). **The first page of the article should not contain the names of the authors.**
- Your introduction should explain the relevance of your study to practice (i.e. the various practical implications), explain what you did, how you did it and show how it adds to the prior literature.

### **Reference technique**

- The Harvard referencing system should be used.
- References should be inserted into the text by indicating in brackets the name of the author(s) and the year of publication of the text from which the quotation or reference is taken, for example, "Smith (1992) states that ...", or "the matching concept is not

applicable for these purposes” (Smith 1992). If the article refers to a particular page, a colon follows the year of publication (no spaces), followed by the page number (again, no spaces), for example, “Smith (1991:14) states that ...”, or “the matching concept is not applicable for these purposes” (Smith 1992:14). If a cited author has more than one publication in any one year, the articles/other works are distinguished by inserting the letters a, b, etc. after the year of publication, for example, “Smith (1992a:14) states that ...”.

- If two authors have contributed to an article, the reference is shown as Smith and Shaw (1992) in the text, or as (Smith & Shaw 1992) in brackets. For three or more authors, the first reference refers to Smith, Shaw and Brink (1992) and thereafter et al. may be used as follows: “Smith et al. (1992) state ...”. Footnotes are not used for reference purposes. Note that the ampersand (&) is used inside the brackets and in the bibliography.

## Layout

- Each drawing or table must be provided with a concise, unique heading.
- Position tables and figures in their final positions (do not append them at the end).
- All figures and tables must be referred to in the text.
- Tables or figures should be reasonably interpretable without reference to the text. Notes should be included as necessary.
- Footnotes should be avoided as far as possible. Footnotes are only permissible when it is necessary to clarify a specific point, and it is undesirable to include the explanation in the text because the logical flow of the argument may be disrupted. Such footnotes appear at the bottom of the page to which they refer.
- Direct quotations from other publications should be avoided. Such quotations are only permissible in exceptional circumstances when the specific quotation is so succinct and vivid that the text may be materially enhanced by the quotation.
- Headings are numbered 1, 2 etc., and sub-headings 1.1, 1.2, etc. More than three characters (points excepted) in a sub-heading are not permissible. All headings and subheadings appear adjacent to the left margin in **bold**.
- Latin words such as *inter alia* or *et al.* appear in italics.
- Numbers between zero and ten are written out as words, numbers from 11 upward are written using figures. Decimals and percentages may be written using figures, for example, 0.543 or 17%. Decimals should be written using a full stop rather than a comma, and the zero before the decimal should be included where applicable, i.e. 0.56, rather than .56..

## **Bibliography**

Publications referred to in the text are listed alphabetically according to the surname of the first author. References to the same author appear in the chronological sequence of publication, and if an author has more than one publication in any one year, the articles are distinguished by adding the letters a, b etc. after the year of publication (see [Reference technique](#) above).

In the case of articles in journals, details of each article should appear in the bibliography in the following sequence: surname, initials (or names, if used in the original publication), year of publication, title of article, name of journal (in italics), date (do not repeat the same year) and/or number and/or volume of the journal, and the page numbers.

In the case of books, details of each book should appear in the bibliography in the following sequence: surname and initials (or names, if used in the original publication), date of publication, title of book (in italics), place of publication (the name of the city, for example, London, and in the case of some US cities the state, for example, Cambridge, Massachusetts) and the name of the publisher.

The bibliography is not subdivided into sections for books, journals, papers, etc.

The lower case is used in article and book titles (except for proper nouns), but the first letter of all words except articles, conjunctions and prepositions in the titles of journals is capitalised.

### **Examples**

Smith, J. 1992. The matching concept. *Accountancy SA*, January:22-44.

Smith, J. 1992. *Accounting theory*. 2nd edition. Cape Town: Juta.

Smith, J. & Shaw, B. 1992. Understanding Accounting. *Meditari Accountancy Research*, 6(1):30-36.

Smith, J., Fraser, A. & Jones, C.F. 1992. The matching concept. *Accountancy SA*, January:22-44.

Smith, J., Shaw, B. & Brink, F. 1992. A taxonomy of Accounting. 9th edition. London: Longman.

South African Institute of Chartered Accountants (SAICA). 1990. Framework for the preparation and presentation of financial statements, AC 000. November, SAICA. Johannesburg: Kengray.

South Africa. 1996. Constitution of the Republic of South Africa, Act 108 of 1996. Pretoria: Government Printer.

The Institute of Internal Auditors. 1999. Membership. <http://www.theiia.org/membership>. Accessed: 2 January 1999.

### **Abstract**

An abstract of approximately 100 words, on a separate page, should accompany each article presented. The abstract should not form part of the text.

### **Language usage**

**It is required that all authors have their draft articles reviewed to ensure grammatical and idiomatic correctness before submitting them to the editor.** Sometimes excellent submissions have to be drastically amended or even rejected because of linguistic ineptitude. The editor or rotating editors reserve the right to make minor editorial adjustments without consulting the author.

The use of abbreviations should be avoided as far as possible, and all acronyms have to be defined where they are first used.

### **Acknowledgements**

Acknowledgements of financial and other assistance should appear on the cover page. Acknowledgements of a personal nature are not permissible.

### **Key words**

Please supply, in alphabetical order, a list of as many key words as possible (up to 15) for cataloguing purposes.

## **Annexure D.2 – Author guidelines: SAJAR**

### **Manuscript submissions**

Authors should submit their manuscripts by e-mail to [sajar@saica.co.za](mailto:sajar@saica.co.za). Alternatively they may submit 3 hard copies to Prof Enrico Uliana, Editor SAJAR, Department of Finance, Bremner Building, University of Cape Town, Private Bag Rondebosch 7701, South Africa. Manuscripts must include an abstract and up to ten keywords. Manuscripts must be free of any identification of the author(s), affiliations, and acknowledgements. A separate sheet should include the title, affiliation, contact address, phone number, fax and email address and any appropriate acknowledgements. The letter to the editor should contain a statement that the manuscript or a similar one has not been published and is not, nor will be, under consideration for publication elsewhere while being reviewed by SAJAR.

The above instructions must be adhered to for resubmission.

### **Manuscript preparation and style**

Manuscripts should be prepared for A4 paper and be 1.5 or double-spaced. Authors are requested to use a 12 point easily legible font, and margins should be at least one inch to facilitate editing.

*References in the text.* Cited information must be identified accurately. The surname(s) or the author(s), year of publication and page number(s) appear in parentheses after the quotation, for example (Coetzee, 2003:2-5), (Brown & Jones, 2003:2-5). Omit the page number(s) if the entire publication is referred to, for example (Berger, 2001). In works by three or more authors the surnames of all the authors should be given in the first reference to such a work, for example 'A recent study (Jones, Smith, Boren & White, 2002) shows ... .' In later references to this work only the first author's name is given, and the abbreviation et al., a comma and the year of publication. For example: (Jones et al., 2002).

*References at the end of the manuscript.* More details about sources referred to in the text must appear at the end of the manuscript under the caption 'References'. All sources must be arranged alphabetically according to the surnames of the first author. If more than one publication by the same author(s) appear in one year they must be distinguished by a, b, etc., for example 2003a, 2003b.

*References from books.* After the year of publication, follows the title. The Edition, Place of publication: publisher, total number of pages:

Steers, R.M. and Porter, L.W. (1991). Motivation and work behaviour. 5th Edition. Singapore: McGraw-Hill.

*References from journals.* After the year of publication, follows the title of the article, title of the journal, volume, number, page(s).

Doyle, R.J. (1983). Gainsharing – A total productivity approach, Journal of Contemporary Business, 11(2):57-70.