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Public Accounting Standard 7 - Borrowing Costs Obtained STCP case

Ana Beatriz Goncalves* , Eduardo Bonifácio* , Filipe Silva* , João Almeida* , Mariana Moreira*, Adalmiro Pereira**, Tânia Teixeira***
**ISCAP-P Porto*
*** ISCAP-P Porto teacher; CEOS member*
**** ISCAP-P Porto teacher*

Abstract: *Public Accounting Standard 7 (NCP 7) - Borrowing Costs is a set of accounting guidelines that sets out the principles for recognizing and measuring borrowing costs by public sector entities. Borrowing costs can have a significant impact on the financial statements of public entities, affecting both the financial result and the balance sheet.*

In this work, we will explore the main aspects addressed by NCP 7, including the recognition of borrowing costs and the possibility of capitalizing these costs. In addition, we will present a simulation of the capitalization of borrowing costs for a public sector entity, namely STCP.

Keywords: *NCP7; IAS; SNC-AP; STCP*

I. Introduction

The purpose of NCP 7 is to promote transparency and comparability of accounting information related to loans obtained by public sector entities. The standard seeks to ensure that borrowing costs are properly recorded, allowing users of financial statements to understand the financial impacts of borrowing.

By understanding and correctly applying NCP 7, public sector entities will be able to present accurate and relevant accounting information related to borrowing costs. This not only meets regulatory requirements, but also provides a solid foundation for informed decision-making by users of financial statements, such as shareholders, managers, regulators and the general public.

I. Theoretical Framework

1. Public Accounting Standard 7 - Borrowing Costs Obtained

NCP 7 – Costs of Obtained Borrowings is one of the Public Accounting Standards of the Accounting Standardization System (SNC).

1.1 goal

The purpose of this NCP 7 is to prescribe the accounting treatment of borrowing costs. In general, the standard requires that borrowing costs be immediately considered as expenses for the period. However, for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset, the Standard allows for their capitalization.

1.2 Definitions

1.2.1 Obtained Borrowing Costs

The definition of borrowing costs, considered in paragraph 2, of NCP 7 is relatively broad: "Borrowing costs: interest and other costs borne by an entity relating to borrowing".

Considering the same paragraph, the Standard identifies some examples of costs that may be included in the definition of borrowing costs:

- Interest on bank overdrafts and loans obtained;
- Amortization of discounts or premiums relating to loans obtained;

- Amortization of ancillary costs incurred in connection with borrowing;
- Financial charges related to finance leases recognized in accordance with NCP 6 – Leases;
- Exchange differences arising on borrowings in foreign currency to the extent that they are viewed as an adjustment to interest cost.

1.2.2 Qualifying Assets

The standard defines an asset that qualifies as an asset that necessarily takes a significant period of time to get ready for its intended use or for sale.

In accordance with paragraph 2 of NCP 7, inventories that require a substantial period of time to put them in a salable condition, administrative buildings, hospitals, infrastructure such as roads, bridges and power generation facilities, are some examples of assets who qualify.

1.2.3 Assets That Do Not Qualify

Assets that do not qualify are inventories or other investments that are routinely manufactured over a short period of time, such as assets that are ready for their intended use or sale when acquired.

1.3 Recognition

The entity shall recognize borrowing costs as an expense in the period in which they are incurred, except where they are capitalized. (Paragraph 3)

Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset may be capitalized as part of the cost of that asset, when future economic benefits are expected to flow to the entity and they can be reliably measured. (Paragraph 4)

1.3.1 Borrowing costs eligible for capitalization

Borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset would have been avoided if expenditures on the qualifying asset had not been made.

There is a difficulty in identifying a direct relationship between certain borrowings and an asset that qualifies and determines which borrowings to avoid.

An example of this happening occurs when an entity's financial activity is centrally coordinated. (Paragraph 7)

In addition to this difficulty, others arise such as when a public group uses various debt instruments to borrow funds at variable interest rates and transfers these funds based on different criteria to other entities in the group.

Funds that have been requested centrally can be transferred to other entities within the group as a loan, grant or equity injection. These transfers may be interest-free or require that only a portion of the actual interest cost be recovered.

The consequence of this is the difficulty of determining the amount of borrowing costs directly attributable to the acquisition of a qualifying asset, requiring the exercise of judgment. (Paragraph 7)

NCP7 defines that to the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization in that asset shall be determined as the actual borrowing costs incurred on that borrowing. during the period less any income relating to the temporary investment of those loans.

The standard emphasizes that financing arrangements for a qualifying asset may require an entity to raise funds and bear borrowing costs before some or all of the funds are used for expenditures on that asset. In determining the amount of borrowing costs eligible for capitalization during a period, any investment income generated from such funds is deducted from the borrowing costs incurred. (Paragraph 8)

In the sense that the funds are borrowed and used with the final objective of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalization must be earned by applying a capitalization rate to the expenses related to that asset. This capitalization rate is obtained through the weighted average of borrowing costs applicable to borrowings contracted by the entity that are outstanding in the period, other than borrowings. It should be noted that the amount of borrowing costs capitalized during a period must not exceed the amount of borrowing costs incurred during the period.

According to paragraph 10, only "the costs incurred by borrowing by the entity may be capitalised. When a controlling entity obtains loans that are transferred to a controlled entity without any or partial allocation of the costs of those loans, the controlled entity can only capitalize the borrowing costs that it has incurred. When a controlled entity receives an interest-free equity contribution or a capital grant, it will not bear any borrowing costs".

When a controlling entity transfers funds to a controlled entity with partial allocation of costs, the latter may capitalize the part of the borrowing costs it has borne. In public group a's financial statements, the full amount of borrowing costs may be capitalized in the qualifying asset provided that appropriate consolidation adjustments have been made to eliminate the costs capitalized by the controlled entity. (Paragraph 11)

When a controlling entity has transferred funds to a controlled entity without allocating costs, neither entity meets the criteria for capitalization of borrowing costs. However, if the public group meets the criteria for capitalization, it may do so, in respect of qualifying assets, in its financial statements. (Paragraph 12)

In certain contexts, it is appropriate to include all borrowings from the controlling entity and its controlled entities to calculate the weighted average borrowing costs. In other situations, it is appropriate for each controlled entity to use the weighted average of the costs relating to its own borrowings.

1.3.2 Excess of the carrying amount of the qualifying asset over the amount

recoverable

NCP 7 defines that, when the carrying amount, or the last expected cost of the qualifying asset, exceeds its recoverable amount or its net realizable value, the carrying amount must be reduced or written off in accordance with the requirements of NCP 9 - Impairment of Assets. In certain situations, the amount of the reduction or cancellation may also be reversed in accordance with this rule. (Paragraph 14)

1.3.3 Beginning of Capitalization

Under Public Accounting Standard 7, capitalization of borrowing costs as part of the cost of qualifying assets must start when:

- The entity incurs expenditures on the asset;
- Borrowing costs are being supported;
- Activities necessary to prepare the asset for its intended use or sale are in progress.

The capitalization period starts from the date all of the above conditions are met and ends when the qualifying asset is ready for its intended use.

According to the rule under study, paragraph 16, expenditures on a qualifying asset include only those that have resulted in cash payments, transfers of other assets or the assumption of liabilities that generate interest.

The average carrying amount of an asset over a period, including capitalization of borrowing costs, is normally a reasonable approximation of expenditures to which the capitalization rate is applied in that period. The average amount of assets carried over a period, including already capitalized borrowing costs, is normally a reasonable approximation of the expenditures to which the capitalization rate is applied in that period.

The activities required to prepare the asset for its intended use encompass more than its physical construction. In addition to the physical construction, it includes technical and administrative work carried out prior to construction, as well as activities associated with obtaining licenses.

However, such activities do not include owning an asset when no production or development that changes the condition of the asset is taking place, as for example where borrowing costs incurred while land is under preparation are capitalized during the period in which activities are taking place. However, borrowing costs obtained while land acquired for building purposes is held without any associated preparation activity do not qualify for capitalisation.

1.3.4 Suspension of Capitalization

The suspension of the capitalization of borrowing costs must be during extended periods in which the development of the qualifying asset is interrupted, and during these periods it must be recorded as expenses. However, capitalization is not suspended during a period when there is substantial technical and administrative work.

Furthermore, the capitalization of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of making an asset ready for its intended use or sale. For example, continued capitalization during the period required for inventories to be ready or the period during which high water levels delay construction of a bridge, if such water levels are common during the construction period in the region involved.

1.3.5 Cessation of Capitalization

For the cessation of capitalization of borrowing costs, all activities necessary for the asset to be ready for its intended use or sale must be completed. (Paragraph 20)

Under paragraph 21, an asset is normally ready for its intended use or sale, although routine administrative work may continue when its physical construction is complete. If all that remains to be completed are minor modifications, such as furnishing a property to the buyer's or user's specification, then all activities are substantially complete.

NCP 7 also provides that, when the construction of a qualifying asset is completed in parts and each part is able to be used while construction continues on other parts, the cessation of capitalization of borrowing costs obtained must take place when all activities necessary to prepare that part are substantially completed.

II. Practical Application

2. Practical Case

2.1 Framework

This chapter aims to frame the practical application of this work, in which it is proposed to analyze the impacts of applying the rule on recognition of the costs of loans obtained and attributable to assets, in the two options available in the national rule: to capitalize or not these costs.

As an object of study, it was decided to use the financial statements of STCP, whose activity is carried out in the area of transport, namely the impact of loans contracted in the year 2020 on the financial statements for the year 2021. In this case, and according to the Report of Company accounts, the loans taken out were as follows:

"In 2020, the Portuguese State granted four loans to STCP, in the following amounts:

- **11,573,579.17 euros**, to meet the financing needs associated with the debt service of the bond loan and the charges with the swap contract, authorized by Order of the Secretary of State for the Treasury No. 206/2020-SET, of 2 June.
- **2,700,000.00 euros**, to finance the operating deficit as a direct result of the effects of COVID, authorized by Order of the Secretary of State for the Treasury nº 786/2020, of 25 November.
- **12,447,219.63 euros**, with a view to meeting the financing needs associated with debt service, namely the payment of charges associated with the swap coupon, as well as the interest on the bond loan, authorized by Order of the Secretary of State for the Treasury No. 792/2020SET, of November 26th.
- **8,054,611.00 euros**, intended to finance the operational deficit verified in 2020 and justified by the situation resulting from the COVID-19 pandemic, authorized by the Dispatch of the Secretary of State for the Treasury nº 924/2020 – SET, of December 29."

However, in 2021, no types of loans were capitalized, because all loans taken out were used to support financial needs and not invested in the purchase or acquisition of assets that could generate financial return for the company.

2.2 Impact of Borrowing Cost Capitalization on Financial Statements

Taking into account the non-capitalization of the loans, we proceeded, instead, with a simulation of what would be the changes that would occur in the income statements if there were an investment by STCP in assets that represented a financial return for the company. The differences would be at the level of the following headings:

Revenues: Generally, there is no difference in revenues due to the capitalization of the borrowing cost. Revenues are recorded based on sales of the company's products or services and are not affected by the accounting treatment of the loan.

Cost of Goods Sold (CPV) or Cost of Services Provided (CSP): The COGS or CSP may be indirectly affected by the capitalization of the cost of the loan, if the loan is used to directly finance the production or provision of services related to the asset.

In this case, part of the loan interest is capitalized and incorporated into the COGS or CSP, increasing these costs.

Operational expenses: Operating expenses are generally not directly affected by capitalizing the borrowing cost on an asset. These expenses, such as selling expenses, administrative expenses, research and development, are normally recognized as expenses in the period in which they are incurred, regardless of the accounting treatment of the specific loan.

Financial expenses: The capitalization of the cost of borrowing directly affects financial expenses. Rather than recording interest expenses as an immediate expense on the income statement, they are incorporated into the cost of the acquired asset. Subsequently, they are amortized over the useful life of the asset and recorded as amortized financial expenses in the income statement.

Profit/Loss Before Taxes: Capitalizing the cost of borrowing on an asset can affect pre-tax profit or loss. If the amortized interest expense is less than the interest expense that would have been recognized immediately, this may result in a higher pre-tax profit than would have been the case if the borrowing cost had not been capitalized. However, it is important to consider that other items, such as asset depreciation, can independently affect pre-tax profit or loss.

However, it is possible to draw more conclusions about the effects of compounding loans into assets, such as:

- **Effect on the Balance Sheet:**The capitalization of a loan results in an increase in the company's assets and liabilities. The loan amount is recorded as an asset (commonly referred to as "Capitalized Borrowing Cost") and the corresponding liability is recorded as a liability. This can affect the company's financial position on the balance sheet.

- **Deferral of Financial Expenses:**By capitalizing the cost of the loan, the financial expenses are deferred over the useful life of the related asset. This allows the company to spread the recognition of finance costs over time, rather than immediately recognizing them as expenses. This practice may result in a deferred impact on the income statement, with a potential increase in pre-tax earnings in the early stages.

- **Impact on Income Statements:**The capitalization of the borrowing cost can affect several line items in the income statement. Financial expenses will be amortized and recorded as amortized financial expenses over the useful life of the asset. This can affect pre-tax profit, which could result in an increase in early stages and a decrease in subsequent stages.

- **Impact on Financial Analysis:**The capitalization of the cost of borrowing can influence the company's financial metrics and indicators. For example, pre-tax earnings can be affected in the early years, leading to a more favorable appearance of profitability. However, it is important to look at financial statements holistically and consider long-term effects such as loan amortization.

- **Compliance with Accounting Standards:**Capitalization of borrowing cost must follow applicable accounting standards, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS). Compliance with these standards is essential to ensure the consistency and transparency of financial statements and facilitate comparison with other companies in the sector.

In summary, the capitalization of a loan can have significant financial statement implications, affecting both the balance sheet and income statements. It is critical to understand the applicable accounting standards and consider the specific context of the company when interpreting the impacts of cost of borrowing capitalization on corporate finances.

2.3 Simulation of a capitalization of a possible loan

We now simulate a hypothetical situation in which STCP invests 1.5 million euros in the acquisition of 5 buses for the transport of passengers, which will result in an increase in revenue.

Simulating the possible revenue that each bus would generate, STCP, in 2021, had revenue of €33,460,000. If we divide this by the 420 buses that STCP has in its fleet, it will amount to €797.00 per bus, which, multiplied by the 5 buses purchased, will give €398,333 in additional revenue. We also assumed that the cost of services provided by the company would not change.

Capitalization of a loan occurs when the loan is recorded as an asset on the company's balance sheet. In that case, the €1.5 million loan would be recorded as an asset on the company's balance sheet. The capitalization of the loan would affect the following balance sheet items:

- **Non-Current Assets or Fixed Assets:**The total loan amount of €1.5 million would be recorded as a non-current asset or fixed asset on the company's balance sheet. This item reflects the long-term assets that the company owns, such as fixed assets, investments and properties.
- **Liabilities:**The loan amount would also be recorded as a liability on the balance sheet under liabilities. This represents the company's obligation to repay the loan amount in the future.
- **Net worth**: If the capitalization of the loan is recorded as part of the company's equity, this would be reflected in the equity item on the balance sheet.

The additional revenue of €398,333 resulting from the acquisition of buses is not directly related to the capitalization of the loan. The additional income would be recorded on the company's income statement, also known as the income statement, as an income item.

The income statement is made up of several headings that describe the company's revenues, expenses, and profits over a given period of time. The main items that would be affected by the €398,333 additional revenue would include:

- **Operating income:**The additional income would be included as an operating income on the income statement, increasing the company's total operating income.
- **Gross profit:**The additional revenue would also increase the company's gross profit, which is calculated by subtracting cost of goods sold from operating revenues.
- **Net profit:**After deducting all operating expenses (such as administrative expenses, selling expenses, depreciation, etc.) from gross profit, net profit would be affected by additional revenue. This would result in an increase in net income, which may be favorable for the company.

Furthermore, additional expenses would also increase as drivers would have to be hired to drive the buses.

III. Conclusion

According to the information made available in the Accounting Standardization System for Public Administration, specifically NCP 7 - Cost of Obtained Loans, it was possible to achieve the objectives proposed for this work. The main objective of this work involved the analysis and theoretical understanding of NCP 7 and, subsequently, the respective practical application for the public entity STCP.

Having carried out the analysis of the standard, a practical framework was carried out in relation to the selected entity, exposing the different amounts of loans granted by the Portuguese State to STCP, concluding that it does not carry out capitalization of any type of loans.

Finally, a simulation was carried out if there was investment in assets that represented a financial return for the company. In this way, it was verified that the purchase of 5 buses would cause, among others, an increase in net profit favorable to the company, an increase in the company's assets and liabilities and an increase in additional expenses, since the entity would have to contract drivers to make use of the investment.

In short, it is possible to conclude that capitalization can impact the financial statements, changing both the balance sheet and the income statements.

Webgraphy

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