Capitalization of Exchange Loss related to Borrowing cost

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Introduction

ABC Company has obtained a USD 30 million bank loan on 1st May 2013 for the purpose of constructing a new building. This loan is directly attributable to the construction of the building and the loan term is five years bearing 6.27% interest rate. However LKR Loan interest rate prevails in the market is amounting to 14.25% which is higher than the FCBU Loan interest rate. The main reason for charging a low interest rate for the FCBU loan is the cost arising from exchange rate. The company has started to capitalize full exchange gain/loss arises from the FCBU Loan as it directly relates with the construction of the building.

Discussion of the Issue

According to this case, company has started to capitalize the exchange loss. As it directly relates to the FCBU loan & the company argued that it arises as a result of the construction. According to the LKAS 23 Borrowing cost;

- It is compulsory for an entity to capitalize borrowing cost that are directly attributable to the acquisition, construction or production of qualifying asset
- Capitalization of borrowing cost should cease when all activities are completed to prepare the qualifying assets for its intended use

The company has obtained this loan for the purpose of constructing a building and it takes substantive period for the asset to bring it to a usable condition. Therefore this asset can be identified as a qualifying asset and the interest charges related to the asset can be capitalized under borrowing cost. The asset is not yet completed and the company has capitalized interest charge and the exchange losses under capital working progress. During the audit, engagement team identified that the exchange loss of the FCBU loan has been capitalized under PPE in capital working progress. Therefore the capital working progress amount has overstated.
**Implication**

According to this situation, if the company capitalize the exchange loss, capital working progress amount will be overstated and it affect to the depreciation in subsequent years. Since this is a FCBU Loan, the interest rate is lower than the market interest rate for the LKR Loans. Therefore the interest expense capitalized as a borrowing cost is lower than the market interest expense related to the LKR loan. Because of that the exchange loss related to the FCBU loan can be capitalized up to the interest charge related to the LKR loan.

**Conclusion and Recommendation**

According to this issue, the company cannot capitalize the full amount of the exchange loss; instead the company can capitalize the exchange loss up to the LKR interest charge relating to the FCBU loan. Because the FCBU Interest rate is less than the market interest rate of the LKR Loan & company incurred cost for repayment loan and interest in foreign currency.

- Total exchange loss of the FCBU account = Rs.630,000,000
- Interest expense of the FCBU loan = (30000000 *151.875) *0.0627 = 283,125,000
- Interest expense of the FCBU loan @ LKR rate = (30,000,000*151)*0.145 = 656,850,000

According to this situation, the company cannot capitalize the full amount of exchange loss as borrowing cost, as it is more than the LKR interest amount.

- Allowable interest expense for borrowing cost = 656,850,000
- FCBU Interest expense = 283,125,000
- Allowable exchange loss for capitalization = (656,850,000-283,125,000) = 373,725,000

Therefore the company needs to identify the balance exchange loss of the FCBU loan as a finance expense.

\[
\begin{align*}
\text{Exchange loss} & \quad \text{Dr} \quad 256,275,000 \\
\text{Capital work in progress} & \quad \text{Cr} \quad 256,275,000
\end{align*}
\]

(Recording the disallowable exchange loss as expense)

The team recommended that the exchange loss of the FCBU loan can be capitalized up to the interest amount of the LKR interest rate and the excess exchange loss needs to identify as a finance expense.