



THE COST OF BORROWED CAPITAL: ACCOUNTING FOR INTEREST EXPENSES AND FINANCIAL LIABILITIES UNDER CONTEMPORARY REPORTING STANDARDS

Ravupova Makhliyo Daminovna

Student, Samarkand Institute of Economics And Service

Abstract: Interest expense is one of the most consequential figures on an income statement, yet its measurement and recognition remain riddled with interpretive complexity that standard-setters have never fully resolved. This article examines how entities account for interest costs and their associated liabilities under both IFRS and US GAAP, with particular attention to the effective interest method, the classification of financial instruments, and the fair value option. Rather than treating these as settled technical matters, the article surfaces the genuine ambiguities that practitioners confront — from the boundary between borrowing costs eligible for capitalisation and those that must flow through profit or loss, to the asymmetric treatment of own credit risk under the fair value option. The discussion draws on the requirements of IFRS 9, IAS 23, IAS 32, ASC 835, and ASC 470, while acknowledging that no amount of standard-setting eliminates the role of judgment. The central argument is that the current framework, while largely coherent, rests on assumptions about market behaviour and management intent that do not always hold in practice, and that preparers, auditors, and users of financial statements all benefit from engaging with these tensions rather than papering over them.

Keywords: interest expense, financial liabilities, effective interest method, IFRS 9, fair value option.

Introduction

Debt is not free. This is the irreducible starting point of any discussion about interest expense — and yet the ways in which entities measure, recognise, and disclose the cost of their borrowings have become elaborate enough to obscure that basic truth. Walk through the financial statements of a large industrial conglomerate or a mid-sized bank, and the interest figures you encounter are the product of layered accounting choices, some mandated by standard-setters and others left to the discretion of management. Understanding what those numbers actually represent requires familiarity not just with the rules, but with the underlying logic — and the places where that logic breaks down.

Interest expense arises whenever an entity uses borrowed funds. In its simplest form, it is the periodic cost of a loan: a company borrows at five



percent per annum, pays interest quarterly, and records the expense each period as it accrues. But the reality that corporations inhabit is rarely so clean. Bonds are issued at a discount or a premium. Loans carry origination fees that affect the effective yield. Convertible notes straddle the boundary between debt and equity, forcing preparers to decompose a single instrument into two components before they can even begin recognising interest. Revolving credit facilities are drawn and repaid in patterns that make any static calculation unreliable. And then there is the question of borrowing costs that relate to the construction of an asset — whether those costs should be expensed immediately or capitalised and folded into the asset's carrying amount.

What makes the accounting for interest expenses and financial liabilities particularly interesting, academically and practically, is that it sits at the intersection of several broader debates in financial reporting. How should financial instruments be measured — at cost or at fair value? When does an instrument constitute a liability at all, rather than equity? How should the income statement reflect changes in an entity's own credit risk? These questions have occupied standard-setters for decades and have produced frameworks that are, in the main, workable but not without significant fault lines.

This article traces those fault lines. It begins with the conceptual foundations of interest expense recognition — what interest represents and why its measurement is not as straightforward as it appears. It then examines how financial liabilities are classified and initially measured, since that classification determines everything that follows. The third substantive section addresses the effective interest method in depth, including its logic, its application, and the difficulties that arise when contractual cash flows are uncertain or subject to modification. The article then turns to compound instruments, the fair value option, and the treatment of borrowing costs before addressing the persistent differences between IFRS and US GAAP. A concluding section draws together the main threads and offers some thoughts on where the current framework could be strengthened.

What Interest Expense Actually Represents

At its core, interest is the price of time — the compensation a lender demands for parting with liquidity now in exchange for repayment later. This is not merely a theoretical observation. It has direct accounting implications. If interest is the cost of time, then its measurement must account for the full duration of a borrowing arrangement, not just the periods in which cash changes hands.

This is why accrual accounting — the principle that income and expenses should be recognised when they are earned or incurred, rather than when cash



is received or paid — is so central to interest accounting. A bond that pays a coupon annually generates interest expense continuously over the twelve months between payments, not just at the moment of payment. The matching principle reinforces this: the cost of borrowing should be recognised in the same periods as the economic activity those borrowed funds support.

But there is a subtler point embedded in the concept of interest. When a bond is issued at a discount — when the proceeds received are less than the face value that will eventually be repaid — the discount itself represents additional compensation to the bondholder. The effective interest rate on the bond exceeds the coupon rate because the issuer is, in effect, paying back more than it received. Conversely, a bond issued at a premium carries an effective rate below its coupon. In both cases, recognising only the cash coupon payments as interest expense would misstate the true cost of the borrowing. The mechanics of the effective interest method exist precisely to address this.

There is also the matter of transaction costs. When an entity arranges a loan, it typically incurs fees — arrangement fees, legal costs, commitment fees, underwriting commissions. Under both IFRS 9 and US GAAP, these costs are not expensed immediately but are deducted from the initial carrying amount of the liability (or added to it, depending on the instrument). They then get amortised as part of interest expense over the life of the borrowing, using the effective interest method. The effect is to increase the effective interest rate above the contractual rate, which is the appropriate treatment: these costs are part of the total consideration paid for access to borrowed funds.

Understanding interest expense this way — as the total cost of a borrowing over its life, allocated systematically to each period — is the lens through which the entire accounting framework makes sense.

The Classification of Financial Liabilities: The Prerequisite for Everything Else

Before an entity can begin measuring or recognising interest expense, it has to answer a prior question: is this instrument a financial liability at all?

Under IAS 32 (and the equivalent guidance in ASC 480), a financial liability is an obligation that will be settled by delivering cash or another financial asset, or by exchanging financial instruments under potentially unfavourable conditions. The distinction between liability and equity is fundamental — not because the accounting mechanics differ modestly, but because they differ entirely. Equity instruments generate distributions, not interest expense. Misclassifying a liability as equity keeps interest expense off the income statement and removes the obligation from the balance sheet. The incentive to misclassify, in other words, is real.



IAS 32 cuts through this by focusing on substance over form. An instrument is a financial liability if the issuer has a contractual obligation to deliver cash — even if that obligation is contingent, or arises only upon redemption, or is dressed up in equity-like language. Mandatorily redeemable preference shares are a classic example: despite being called shares, they must be settled in cash, and so they are classified as financial liabilities under IFRS. The dividends paid on them are interest expense, not equity distributions.

Once an instrument is confirmed as a financial liability, IFRS 9 requires it to be assigned to one of two measurement categories: amortised cost or fair value through profit or loss. The default is amortised cost, which is appropriate for most conventional debt instruments — loans, bonds, notes payable, finance lease liabilities. The fair value through profit or loss category applies either mandatorily (for instruments held for trading) or through an irrevocable election at initial recognition — the so-called fair value option, discussed later.

Initial measurement, regardless of subsequent category, is at fair value. For most liabilities, this equals the transaction price — the proceeds received, adjusted for any transaction costs that are directly attributable to the issuance. This is a seemingly technical point with important consequences. If a bond is issued at a significant premium or discount relative to market rates, the initial carrying amount reflects those market rates, not the contractual ones. The whole subsequent accounting flows from this starting point.

The US GAAP framework, primarily ASC 470, is broadly similar in structure but differs in some specifics. Notably, ASC 480 uses a narrower definition of mandatory settlements, and the boundaries of what must be classified as a liability are drawn slightly differently. These differences are not cosmetic; they can affect whether, say, a puttable instrument appears on the balance sheet as debt or equity, with consequent effects on reported interest expense.

The Effective Interest Method: Logic and Application

The effective interest method (EIM) is the engine of interest expense accounting, and it is worth spending time on it — not because it is obscure, but because its logic is frequently misunderstood, even by experienced practitioners.

The central concept is the effective interest rate (EIR): the rate that exactly discounts the estimated future cash flows of a financial liability to its initial carrying amount. In a straightforward fixed-rate bond with no transaction costs and no discount or premium, the EIR equals the coupon rate. But in any other scenario, it will differ — sometimes significantly.

Consider a ten-year bond with a face value of \$10 million, carrying a coupon of four percent payable annually, but issued for proceeds of \$9.2



million because market rates at issuance were five percent. The initial carrying amount is \$9.2 million. The EIR is five percent. Interest expense in the first year is not four percent of \$10 million (\$400,000) — it is five percent of \$9.2 million (\$460,000). The difference, \$60,000, is added to the carrying amount rather than paid in cash; it represents the accretion of the discount. By year ten, the carrying amount reaches \$10 million, at which point the bond is repaid. Total interest expense over the life of the bond is \$4.8 million — exactly equal to the total cash outflows ($\$400,000 \times 10 = \$4,000,000$ in coupons plus \$800,000 discount repaid at maturity) minus the carrying increment.

This is the method working as intended. The pattern of interest expense follows the pattern of the outstanding balance, which is precisely what the time-value-of-money concept demands.

The application becomes considerably more difficult when cash flows are uncertain. Variable-rate instruments pose an obvious challenge: the EIR must be recalculated when rates change, because the discount rate used at inception may no longer reflect current contractual cash flows. Under IFRS 9, entities are required to recalculate the gross carrying amount using the original EIR applied to revised expected cash flows when modifications or changes in estimates occur, with the resulting adjustment recognised immediately in profit or loss.

Prepayable instruments add another layer of complexity. A loan that the borrower can repay early — or that the lender can accelerate — has uncertain cash flows by nature. The EIR must incorporate assumptions about the timing and likelihood of prepayment. If those assumptions turn out to be wrong, the entity must adjust. IFRS 9 addresses this through the concept of expected cash flows, rather than merely contractual cash flows, for instruments with prepayment features.

The treatment of step-up interest rates is subtler still. Some bonds carry interest rates that increase over time — two percent for the first three years, four percent for the next four, and so on. Under the EIM, these stepped cash flows are not recognised as expense according to the contractual schedule. Instead, the EIR — a single constant rate — is applied to the carrying amount each period, creating interest expense that differs from the cash actually paid. The difference accumulates on the balance sheet as accrued interest until the higher contractual payments bring the carrying amount back into alignment.

What emerges from all of this is that the EIM is not just a mechanical calculation. It requires entities to make and update estimates about cash flows, to choose discount rates, and to handle deviations between expected and actual outcomes. These are judgment calls, and they create room for variation between entities even when the underlying economics are similar.

Compound Instruments and the Separation Problem



Some financial instruments combine features of both debt and equity in a single contractual arrangement. Convertible bonds are the paradigmatic case: they carry an interest obligation (making them debt-like) but also give the holder the right to convert into equity shares (making them equity-like). Under IFRS, the issuer must separate these two components at inception and account for them independently.

The mechanics of this bifurcation are dictated by IAS 32. The liability component is measured first, as the present value of the contractual cash flows — coupons and principal — discounted at the market rate for a comparable non-convertible instrument. The residual of the proceeds after deducting the liability component is assigned to the equity component and recognised in equity. Once separated, the liability component is subsequently measured using the EIM with the rate determined at inception; it is not remeasured even if the conversion option changes in value.

The consequences for interest expense are notable. Because the liability component is recorded at a discount to face value (the equity component absorbs the difference between total proceeds and the present value of cash flows), the EIR applied to the liability component exceeds the coupon rate. Interest expense on a convertible bond is higher than the coupon — sometimes significantly higher. This reflects economic reality: the bondholder has accepted a below-market coupon in exchange for the conversion option, and the issuer's true cost of debt is the coupon rate grossed up to reflect that concession.

US GAAP has historically taken a different approach. Until the issuance of ASU 2020-06, entities were required to bifurcate convertible instruments under certain circumstances, but the rules were narrower than under IAS 32, and many convertible bonds were accounted for as simple debt without any equity component. ASU 2020-06 simplified this — in one direction by eliminating certain bifurcation requirements, in another by changing how diluted EPS is calculated for convertible instruments. The practical result is that IFRS and US GAAP now treat similar convertible instruments differently, which complicates comparisons between entities reporting under the two regimes.

The Fair Value Option: What It Offers and What It Obscures

Both IFRS 9 and ASC 825 permit entities to designate financial liabilities at fair value through profit or loss upon initial recognition — an election that cannot be reversed and that is available only if it eliminates or significantly reduces an accounting mismatch, or if the liability is managed and evaluated on a fair value basis.



The fair value option sounds appealing. It aligns the measurement of liabilities with the measurement of related assets, reduces volatility that might otherwise arise from mismatched accounting bases, and provides users with what proponents argue is more decision-relevant information. There is something to this. A bank that manages its assets and liabilities together on a fair value basis can argue that presenting both at fair value on the balance sheet gives a more faithful picture of the net economic position.

But the fair value option for liabilities carries a feature that troubled standard-setters for years and continues to confuse many users: when an entity's own credit quality deteriorates, the fair value of its liabilities falls — and under full fair value accounting, this generates a gain. The logic is technically sound: a liability that will be settled at a lower probability of repayment is worth less to the holder, and therefore less to the issuer. But reporting a gain at precisely the moment when the entity is in financial difficulty strikes many analysts as perverse. A company whose bonds trade at sixty cents on the dollar because of imminent insolvency is not, in any meaningful sense, forty cents better off.

IFRS 9 addressed this — though only partially — by requiring that changes in fair value attributable to own credit risk be recognised in other comprehensive income (OCI) rather than in profit or loss. This applies to financial liabilities designated at fair value through profit or loss unless doing so creates an accounting mismatch. The effect is that the gains from credit deterioration do not flow through the income statement, though they still appear on the balance sheet and in equity. US GAAP, under ASC 825, has a similar requirement for changes in fair value attributable to instrument-specific credit risk.

Where the fair value option affects interest expense accounting specifically is that, under fair value measurement, there is no EIM and no amortisation of discount, premium, or transaction costs. Instead, total fair value changes are disaggregated — into interest accrual, credit-related changes, and other market-rate movements — and presented accordingly. The practical complexity of this disaggregation is significant, and the disclosures required can run to several pages in a set of financial statements.

The Capitalisation Question: When Interest Becomes an Asset

One of the most consequential choices in interest accounting is whether a borrowing cost should be expensed in the period it is incurred or capitalised — added to the cost of a qualifying asset under construction.

IAS 23 requires capitalisation of borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset. A qualifying asset is one that necessarily takes a substantial period of time to



get ready for its intended use or sale — a power plant, a ship, a commercial property development, a large-scale infrastructure project. The logic is clean: the interest cost incurred during construction is as much a part of the asset's cost as the bricks and labour. Expensing it immediately while activating those other costs would understate the asset and front-load expenses in a way that does not reflect the economic substance.

But the application is difficult. Most entities do not borrow specifically for a single qualifying asset — they borrow generally, and then use those funds for various purposes. IAS 23 addresses this with a capitalisation rate: the weighted average of the borrowing costs applicable to all borrowings outstanding during the period, applied to expenditures on the qualifying asset. This involves a calculation that blends specific and general borrowings in a way that can produce quite different results depending on the composition of an entity's debt portfolio.

US GAAP, under ASC 835-20, has a similar framework but handles the treatment of investment income on temporarily invested borrowed funds differently. Under IFRS, if specifically borrowed funds are temporarily invested while waiting to be used on the qualifying asset, investment income offsets the borrowing costs eligible for capitalisation. Under US GAAP, investment income is not offset in this way. The result is that an entity reporting under US GAAP may capitalise higher gross interest costs — even if the economics of the arrangement are identical.

Capitalisation must cease once the qualifying asset is substantially complete, which is another judgment call. An entity building a manufacturing plant might argue that each production hall is separately ready for use as it is completed, triggering the cessation of capitalisation for that portion of the asset. Another might treat the facility as a single asset and continue capitalising until the entire complex is operational. Neither position is obviously wrong, but the choice affects the timing of interest expense recognition materially.

Judgment, Uncertainty, and the Limits of Standard-Setting

The discussion so far might give the impression that the accounting for interest expenses and financial liabilities, while technically demanding, is a matter of applying clear rules to known facts. It is not. At almost every point, the framework requires judgment — and that judgment is exercised under uncertainty.

Consider loan modifications. When the terms of an existing loan are renegotiated — perhaps because the borrower is in financial difficulty, or because market conditions have shifted — IFRS 9 requires the entity to assess whether the modification is substantial. If it is, the original liability is derecognised, and a new one is recognised at fair value, generating an



immediate gain or loss. If not, the carrying amount is adjusted to reflect the present value of the revised cash flows using the original EIR, with the adjustment recognised in profit or loss. The threshold for "substantial" is defined partly quantitatively — a ten percent difference in the present value of cash flows triggers derecognition — but partly qualitatively: changes in currency, introduction of equity conversion features, or changes in the nature of the instrument may also be substantial regardless of the quantitative test.

These judgments matter enormously. An entity that concludes a modification is not substantial avoids recognising a gain or loss and continues using the original EIR. One that concludes the modification is substantial may recognise a significant gain — particularly if prevailing market rates have risen since original issuance, making the present value of the old cash flows, discounted at the new market rate, lower than the carrying amount. The economic substance may be identical; the accounting may diverge by millions.

Debt modifications in the context of financial difficulty raise additional sensitivities. When a lender agrees to restructure a troubled loan — extending the term, reducing the interest rate, or forgiving a portion of principal — the accounting treatment intersects with standards on impairment, troubled debt restructurings (under US GAAP), and the recognition of forgiven amounts as income. Under IFRS 9, the derecognition of a financial liability is tightly controlled: a liability is derecognised only when it is extinguished — when the obligation is discharged, cancelled, or expired. Merely renegotiating terms does not extinguish the liability unless the modification is substantial as defined above.

The requirement to assess expected cash flows for impaired financial assets (though assets rather than liabilities) also has implications for entities on the other side of the transaction — when an entity's own borrowings include receivables that are also subject to expected credit loss assessments by the other party. The interconnected nature of borrower and lender accounting is often overlooked in textbook treatments.

IFRS and US GAAP: Where They Converge and Where They Do Not

The long project of convergence between IFRS and US GAAP — which consumed considerable energy at the IASB and FASB from the early 2000s through the mid-2010s — produced meaningful alignment in several areas relevant to this discussion. Both frameworks now use the EIM as the primary basis for interest accrual on amortised cost liabilities. Both require transaction costs to be factored into the EIR. Both have fair value option provisions with OCI treatment for own credit risk changes. In broad outline, the two regimes reach similar destinations.



The divergences, though, are real and consequential. Three are worth highlighting.

First, the treatment of convertible instruments, as noted earlier, differs significantly. Under IFRS, IAS 32 requires the separation of liability and equity components for most convertible bonds, producing higher interest expense than an unseparated instrument would generate. Under US GAAP post-ASU 2020-06, many convertible instruments are no longer bifurcated, which means that interest expense reflects only the contractual coupon rate rather than the higher EIR that bifurcation would produce. Analysts comparing the leverage and interest coverage ratios of a European and an American issuer of similar convertible bonds need to be aware of this structural difference.

Second, the definition of what constitutes a financial liability for instruments with equity-linked settlement features is handled differently in IAS 32 and ASC 480. Puttable instruments — shares or other instruments that give the holder the right to sell them back to the issuer for cash — are classified as equity under IFRS in certain circumstances (specifically under an amendment to IAS 32 that was controversial from the outset and has been a source of ongoing debate). Under US GAAP, they are typically classified as mezzanine instruments — not quite liability, not quite equity — in a category that appears on the balance sheet between the two but attracts its own accounting requirements. The resulting differences in reported leverage ratios and interest expense are not trivial for capital-intensive entities with complex capital structures.

Third, the treatment of prepayment features in financial liabilities — specifically those with embedded derivatives that might otherwise require bifurcation — is handled more permissively under IFRS 9, which allows certain prepayment features to remain in the host contract without separate accounting, provided the prepayment amount substantially represents unpaid principal and interest. US GAAP has analogous, but not identical, scope exceptions, and the determination of whether an embedded derivative requires bifurcation can diverge in practice for instruments with symmetric prepayment options.

Conclusion

The accounting for interest expenses and financial liabilities is, at one level, a solved problem. Standards exist. The EIM is well established. The required disclosures are reasonably comprehensive. Experienced preparers and auditors navigate this terrain regularly without major incident.

At another level, though, it remains genuinely difficult. The difficulty is not merely technical — it is conceptual. The framework asks preparers to make estimates about future cash flows, to classify instruments that do not fit neatly



into liability or equity categories, to distinguish between modifications that extinguish a liability and those that merely alter it, and to determine when borrowing costs are so closely connected to an asset's construction that they belong on the balance sheet rather than the income statement. Each of these questions involves judgment, and different preparers exercising that judgment in good faith will reach different conclusions.

For users of financial statements — analysts, investors, creditors — the implication is that reported interest expense is not a mechanical fact but a number shaped by measurement choices. The effective interest rate embedded in a financial liability reflects the pricing conditions at inception, the transaction costs that were included, and the assumptions made about contractual cash flows. When those assumptions change, the carrying amount and the prospective interest expense change with them. When the fair value option is elected, interest expense blends with other fair value movements in ways that require careful decomposition.

None of this is a reason to despair about the usefulness of interest expense as a reporting concept — but it is a reason to read the notes. The disclosures that IFRS 7 and ASC 825 require about the methods, assumptions, and inputs used in measuring financial instruments are not boilerplate. They contain the information that makes the headline numbers interpretable.

The accounting profession has built a workable, reasonably principled framework for this area of reporting. The remaining work is not so much standard-setting as it is communication: helping preparers make better-reasoned judgments, helping auditors challenge those judgments more effectively, and helping users understand what the resulting numbers do — and do not — tell them about the true cost of borrowed capital.

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