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**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC.

Paragraph numbers correspond to paragraph numbers used in the IFRIC paper.

However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: September 2006, London

**Project: Provision of Public Sector Services by the Private Sector
[Service Concession Arrangements] (Agenda Paper 2)**

Introduction and papers for this meeting

1. At the July 2006 IFRIC meeting, staff agreed to prepare a draft of the revised text of IFRIC X *Provision of Public Services by the Private Sector* [formerly D12-14] in the light of the IFRIC's post exposure deliberations. Agenda Paper 2 (i) contains that draft text for consideration by the IFRIC. Members are asked if they agree with the draft text and rationale set out in the Basis for Conclusions.
2. Paragraphs 10-13 of this paper outline the upcoming steps of the project. Members are asked if they agree with the proposal.
3. In paragraphs 14-22 of this paper staff propose clarifying the treatment of borrowing costs for an arrangement within the scope of the IFRIC X. Members are asked if they agree with the proposal and rationale.
4. In Agenda Paper 2 (ii) staff considers whether the IFRIC should specify the timing of the recognition of the intangible asset.

Objective of this meeting

5. The objective of the meeting is to reach agreement on the draft text contained in Agenda Paper 2(i). Except as indicated in paragraph 4, no further papers have been prepared for this meeting. It is intended that the rationale set out in the Basis for Conclusions in paper 2(i) provides sufficient explanation. A summary of the main changes from the proposals in D12-14 are set out in BC77 of that paper.

6. IFRIC is asked whether (subject to drafting comments) it agrees with the requirements and rationale contained in Agenda Paper 2 (i).

7. IFRIC is asked whether it agrees with an effective date of 1 January 2008 for IFRIC X.

8. IFRIC is asked whether (subject to drafting comments) it agrees with including the three illustrative examples contained in Agenda Paper 2 (ii) in IFRIC X.

9. IFRIC is asked whether it agrees with the proposed new title of IFRIC X *Provision of Public Services by the Private Sector* and the consequential amendment to title of SIC-29 *Disclosures—Provision of Public Services by the Private Sector*¹.

¹ Current title: SIC-29 *Disclosure—Service Concession Arrangements*

Upcoming steps

10. As noted, a summary of the main changes to the proposals is contained in BC77 of Agenda Paper 2. Staff does not consider that re-exposure of these changes is necessary because, except for the treatment of borrowing costs, the changes made reflect comments made by respondents on the draft proposals.
11. If the IFRIC approves the attached draft in principle at this meeting, the next step will be to take it to the Board. Given the many different aspects of the subject and the range of existing IFRSs referred to, it is expected that the Board may require more than the usual single meeting to complete its review. The IFRIC will be kept informed of any points that arise in the course of that review. To enable the Board review to start at an early date, IFRIC members are asked to provide the staff with any drafting comments by September 22nd (two weeks after the date of this IFRIC meeting).
12. The staff notes that as a service to preparers and other users of IFRSs the IASB makes available near-final drafts of forthcoming standards to give early notice of impending changes before the IASB has finally approved the documents for issue. Near-final drafts may be viewed on the secure online services area of the Website by subscribers to the IASB's Comprehensive Subscription Service. Comments are not specifically invited on near-final drafts. Once the Board has had an opportunity to consider the draft text, it is proposed that it should be made available in this way. The near final draft would remain on the Website until the final Interpretation is published.

13. Does the IFRIC agree with this proposal?
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Borrowing Costs

14. D13 and D14 proposed that if the operator adopted the allowed alternative treatment in IAS 23, it could capitalise borrowing costs attributable to contract activity in accordance with that Standard. In the Basis for Conclusions of D13 and D14, the IFRIC acknowledged that, in most cases, borrowing costs should not be capitalised (see Appendix 1 and 2 for relevant extracts).

15. The staff recommends that the IFRIC clarify the treatment of borrowing costs for arrangements within the scope of the revised draft Interpretation.
16. IAS 23 requires borrowing costs to be recognised as an expense in the period in which they are incurred, except to the extent that they are attributable to the acquisition, construction, or production of a qualifying asset. It defines a qualifying asset as “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.” Paragraph 6 provides examples of when the definition of a qualifying asset is met: “inventories that require a substantial period of time to bring them to a saleable condition, manufacturing plants, power generation facilities and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.”
17. The staff notes that the purpose of the allowed alternative treatment is to reflect the full cost of developing a qualifying asset in the carrying amount of those assets. If an entity purchased a similar asset from a third party, the price would normally include the borrowing costs incurred in constructing the asset.
18. Infrastructure within the scope of the revised draft is not recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to use the infrastructure to the operator. Hence, the infrastructure is not a qualifying asset in the books of the operator.
19. In return for providing construction services the operator receives either a financial asset or an intangible asset. It recognises construction revenue and construction costs in accordance with IAS 11. Under that standard the operator recognises revenue in respect of borrowing costs attributable to a construction contract provided the outcome of the contract can be estimated reliably.
20. Staff propose including the text below in paragraph 22 of IFRIC X and strengthening the Borrowing Costs section of the Basis for Conclusions to better explain the reasons why the allowed alternative treatment is not

available for arrangements within the scope of IFRIC X. In addition, staff propose adding BC 59 to clarify the treatment of borrowing costs when the operator obtains borrowed funds and incurs associated borrowing costs before some or all of the funds are used for expenditure relating to construction or operation services.

Borrowing costs incurred by the operator

22 In the construction and operating phase of the arrangement borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred in accordance with IAS 23.

BC57 IAS 23 *Borrowing Costs* permits borrowing costs to be capitalised as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production. The IFRIC concluded that, for arrangements within the scope of the Interpretation, the infrastructure is not a qualifying asset of the operator. The operator is supplying construction services to the grantor. The infrastructure is not recognised as property, plant and equipment or inventory of the operator.

BC58 Consequently, during the construction and the operation phase of the arrangement, borrowing costs are recognised as expenses in the period in which they are incurred in accordance with IAS 23. It is consistent with the principles of contract accounting to recognise revenue in respect of borrowing costs attributable to a construction contract provided the outcome of the contract can be estimated reliably.

BC59 The IFRIC noted that financing arrangements may result in an operator obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure relating to construction or operation services. In such circumstances the funds are often temporarily invested, any investment income earned on such funds is recognised in accordance with IAS 39.

21. Does the IFRIC agree with this proposal and rationale?

Appendix 1 – Borrowing cost under D13

Content

Consensus	12	If the operator adopts the allowed alternative treatment in IAS 23, it shall capitalise borrowing costs attributable to contract activity in accordance with that Standard. Capitalisation shall cease when required by IAS 23, which is no later than when revenue is recognised in relation to the relevant activity.
Basis for Conclusions	BC12	IAS 11 states that costs that may be attributable to contract activity in general and can be allocated to specific contracts include borrowing costs when the contractor adopts the allowed alternative treatment in IAS 23 <i>Borrowing Costs</i> . IAS 18 provides that costs of contracts for services should be accounted for on a basis similar to that for costs of construction contracts under IAS 11.
	BC13	The IFRIC noted that IASs 11 and 18 require all contract costs to be recognised as expenses as they are incurred, unless they are costs of future activity and specified conditions are met. The IFRIC concluded that an activity can be a future activity only if revenue in respect of that activity will not be recognised until a future date. Therefore, borrowing costs cannot be capitalised on a contract after revenue has been recognised in relation to the relevant expenditure. (In practice, borrowing costs attributable to contract activity for which revenue has not yet been recognised may be immaterial.)
	BC14	This approach is consistent with that of IAS 23, which requires the capitalisation of borrowing costs to cease when substantially all the activities necessary to prepare a qualifying asset for its intended use or sale are complete: once revenue is recognised on an item it has been sold, and therefore must have been ready for sale. The IFRIC concluded that any resulting financial asset is not itself a qualifying asset for the purpose of IAS 23.
	BC15	The IFRIC noted that, after revenue has been recognised, an operator applying the financial asset model will, instead of capitalising interest on its borrowing costs, recognise interest income on the amount due from the grantor (which is a discounted amount), unless it elects to account for the amount due as at fair value through profit or loss.

Appendix 2 – Borrowing cost under D14

Content

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| Consensus | 13 | Subject to paragraph 14, if the operator adopts the allowed alternative treatment in IAS 23, it shall capitalise borrowing costs attributable to the acquisition or production of the intangible asset. IAS 23 requires capitalisation to cease when substantially all activities necessary to prepare the intangible asset for its intended use are complete. |
| | 14 | If the operator has a right to recover its borrowing costs from the grantor (or another party) that is not contingent on other revenues being insufficient to cover those costs, it shall treat the borrowing costs as an expense and recognise revenue in respect of its right of recovery. |
| | 15 | If the operator's right to recover borrowing costs from the grantor (or another party) is contingent on other revenues being insufficient to cover those costs, it is not a right of recovery but an agreement designed to limit the operator's exposure to variations in demand, and shall be accounted for in accordance with paragraph 16. |
| Basis for
Conclusions | BC19 | IAS 23 <i>Borrowing Costs</i> permits borrowing costs to be capitalised as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production. Capitalisation ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete. The IFRIC noted that, for most service concessions, the intangible asset will be ready for use by the time that it has been paid for, either in cash or in the form of construction or other services, if not before. |
| | BC20 | The IFRIC believes that, if an entity has a contractual right to recover borrowing costs, it is consistent with the usual principles of contract accounting to recognise revenue in respect of that right. To avoid double-counting the entity's assets, the finance costs should not be capitalised in these circumstances, but should be recognised in profit or loss. |