Australian Service Concessions

Emerging issues from recent accounting standards

May 2020

Introduction

Service concession arrangements ('SCAs') have become an essential tool for governments to provide public infrastructure assets, such as hospitals, schools, toll roads and prisons. SCAs typically package up financing, construction, operating and maintenance services into one comprehensive arrangement.

For a provider of SCA services (often called the Operator), the accounting has been well established, largely driven by AASB Interpretation 12 *Service Concession Arrangements* ('Interpretation 12'). While Interpretation 12 sets out general pointers for accounting of the Operator's rights and obligations in a SCA, it is an interpretation of a number of accounting standards. Most evident is AASB 15 *Revenue from Contracts with Customers* ('AASB 15'), which guides revenue recognition. Another direct connection is to AASB 9 *Financial Instruments* ('AASB 9'), which guides the recognition and measurement of financial assets.

This publication explores some important issues arising from the interaction of Interpretation 12, AASB 15 and AASB 9 that can impact the financial results of Operators of Australian SCAs.

The interaction of Interpretation 12, AASB 15 and AASB 9 is uncovering new issues, with solutions and practice still evolving. When issued, AASB 15 created a fundamentally different framework for revenue recognition, yet Interpretation 12 received only minor updates in response. Similarly, very few changes were made in response to AASB 9. The illustrative examples in Interpretation 12 also did not change. However, it should be noted that the illustrative examples do not override conclusions reached from applying the accounting standards themselves to the facts and circumstances of each arrangement.

> The interaction of Interpretation 12 and recent standards is uncovering new issues, as some are giving more fulsome consideration of the financial consequences from investing in potential new Australian SCAs.

A recap of the basics of Interpretation 12

To appreciate the issues arising, we recap the key elements of Interpretation 12:

- The infrastructure assets constructed are not recognised by the Operator.
- The Operator recognises revenue from its construction services during building or upgrade, and separately recognises revenue from providing operation and maintenance services.
- A financial asset or an intangible asset model is used to account for the consideration received for construction services, depending on the risks assumed by the Operator.
- Under either model, the Operator's consideration (and revenue) is initially classified as a contract asset during construction or upgrade.
- The Operator recognises revenues (and costs) from operation and maintenance services as and when they are provided.

What important issues arise on interaction of Interpretation 12 and AASB 15?

In a SCA, the Operator generally provides a number of services, such as design, construction, operation and maintenance. As with any contract, the consideration must be allocated to each performance obligation ('PO') (noting that a number of services may form a single PO) so that revenue is appropriately recognised when POs are satisfied.

Incorporating variable consideration into the transaction price

Australian SCAs commonly have significant penalty or abatement mechanisms that apply when performance fails contracted standards, for example, an asset failing to be available during a period of the operating phase. These mechanisms can cause variations in revenue for both construction and operation services.

AASB 15 requires Operators to estimate the value of total consideration taking into account potential variability caused by penalty and abatement arrangements, using a method that best predicts the outcome, such as the "expected value" or "most likely amount" method. Some variable amounts may therefore need to be excluded until uncertainties are resolved. The excluded amounts would be recognised as revenue only after it becomes highly probable that a significant amount will not later reverse.

Operators need to take care when assessing their particular SCA for penalty and abatement mechanisms. In making this assessment on variability, an Operator should consider both the contractual features of its SCA, and previous experience with similar projects involving the same authority granting the SCA.

> Where abatements haven't previously occurred and are expected to be highly unlikely to occur to any material extent, then practically during construction revenue may not be constrained.

Incorporating financing into the transaction price

Most SCAs involve a significant time delay between the Operator providing construction services (generally 2-5 years) and when the Operator is paid, normally over a lengthy post construction operating phase (for example 20-30 years). This delay means the arrangement with the customer (known as the grantor and in this publication, the government) is likely to contain a significant financing component. Where this is the case, AASB 15 requires consideration to be adjusted by discounting it, which then drives the Operator's revenue during construction.

Some Operators have historically defaulted to using the interest rate implicit in the arrangement, determined by discounting the future consideration to an amount equal to the construction costs. While convenient, considerations included the Operator sub-contracting a third party to perform the construction, the risk of stepping into complete the construction left by a failed sub-contractor and materiality, This approach often resulted in more of the profit margin for the SCA being recognised as interest income in the operating phase.

Some may suggest that the rate implicit in the contract more appropriately reflects the economic substance. However, AASB 15 is clear that the objective is to reflect a price the government would have paid for the services if it had paid cash as those services were provided. This is derived by discounting the consideration allocated by using the discount rate that would be reflected in a separate financing transaction between itself and the government at contract inception (as determined from the government's perspective due to it benefiting from payment delays).

There are a range of factors that an Operator should consider in determining an appropriate financing rate. These are discussed further below.

> AASB 15 is clear when isolating the finance component - the objective is to reflect a price the government would have paid if it had paid cash for the services as they were provided.

What important issues arise on interaction of Interpretation 12 and AASB 9?

Timing of transition from a contract asset to a financial asset

As mentioned earlier, an Operator classifies the consideration for performing the construction or upgrade services initially as a contract asset, during the construction or upgrade period. Where the consideration to be received is in the form of a right to charge users (i.e., carrying demand risk), the asset recognised will eventually be an intangible asset upon construction completion. In contrast, where the consideration is to be received are payments from the government (i.e., no demand risk), the asset recognised will eventually be a receivable governed by AASB 9.

However, the transition from a contract asset to a receivable can only occur once the amounts to be received have no conditions, other than the passage of time. While the Operator is obliged to provide services (by also maintaining the asset's performance to meet contracted standards) during the operating phase in order to be paid the consideration for its earlier construction services, the contract asset remains conditional and does not transition to a receivable.

Operators will need to assess the terms of each arrangement to determine the point(s) in time when all (or some) payment for completed construction services is no longer conditional on the future delivery of other services. As it is common for some Australian SCAs to have penalty or abatement mechanisms that can modify amounts to be received by the Operator during the operating phase for construction services previously provided, this is likely to delay contract assets becoming receivables. It may be that the Operator doesn't have an unconditional right until each monthly or quarterly service payment is invoiced or nears its due date, in which case the contract asset gradually transitions to a receivable over the operating phase.

Basis of measurement and value changes for a receivable

Transition of a contract asset to a receivable involves initially recognising a financial asset. This triggers measurement at fair value under AASB 9 and AASB 13 *Fair Value Measurement* ('AASB 13'), which may differ from the carrying amount of the contract asset. As a consequence, a gain or loss may arise on transition that is recognised immediately in profit or loss.

Operators should consider the fair value of the receivable on initial recognition. A significant difference from the carrying amount of a contract asset could exist for example, when the construction period is lengthy, all consideration to be received for construction services becomes unconditional *immediately* upon construction completion (unusual for Australian SCAs where they have abatements that can apply during the operating phase), and the Operator collects these payments over an extended subsequent period. This arises because market interest rates and the credit spread for the government may change from when the SCA was contracted, and in this example *all* future cash flows become unconditional and so are to be revalued in the receivable at construction completion.

> For Australian SCAs with penalty or abatement regimes, recognising a value change on transition to a receivable may be inconsequential, especially when there is little further delay to collecting the next monthly or quarterly service payment.

Once a receivable is recognised, it is carried at fair value, unless amortised cost applies. To use amortised cost, the receivable should be held by the Operator with the objective of collecting the contractual cash flows (usually the case), and should comprise solely payments of principal and interest ('SPPI'). An Operator may consider the SPPI test is met, particularly when it recognises a receivable upon invoicing or nearing the due date of each monthly or quarterly service payment.

How to determine a market-based interest rate to use for the financing component?

AASB 15 requires the consideration receivable for construction services to be adjusted by discounting it using a market-based interest rate determined as if the Operator were to have hypothetically entered into a separate financing transaction, at contract inception with the government. The discount rate is held constant for the duration of the SCA, with no updates for changes in interest rates, credit risk or other circumstances.

When determining the discount rate to use, the factors that Operators might take into account include:

- expected duration and repayment pattern for the tenor of the service payments, noting that many SCA payments extend significantly longer than the duration of most government bonds
- credit profile of the government entity
- borrowing rates that may be offered by the central treasury function of the government, especially where for example, it may be procured through a government-owned corporation
- credit risks specific to the terms of the SCA, including security or guarantees provided by government (including its Treasury), whether express or implied by statute/legislation, and to the extent it impacts the rate that would be negotiated between the parties, and
- any administration costs and profit margin related to financing.

Other relevant factors may also need to be considered depending on the arrangement.

> Adding a spread to bond rates for duration differences and making other adjustments, may not equal the implicit rate and therefore more revenue is recognised during construction.

To discuss further, please contact your local EY adviser.

AUNZ00001354
ED None