

AASB Staff Issues Paper

Service Concession Arrangements (Grantor) Project – Should a grantor recognise revenue or a liability in accounting for a service concession arrangement under the intangible model?

Introduction

- 1 The purpose of this paper is to consider whether a grantor (a public sector entity) should recognise revenue or a liability in accounting for a service concession arrangement in which the grantor transfers to an operator (a private sector entity) a right to charge users in exchange for the operator constructing, maintaining and operating a public infrastructure asset.
- 2 The remainder of this paper is structured as follows:
 - (a) Overview of service concession arrangements
 - (b) Issue
 - (c) Prior AASB discussions
 - (d) Options
 - (e) Other government licenses
 - (f) Staff recommendation

Overview of service concession arrangements

- 3 In a service concession arrangement, a grantor arranges for a private sector operator to design, finance, and build infrastructure and provide operational or management services in relation to the infrastructure asset for an agreed period (the concession period)
- 4 The principal features of a service concession arrangement are as follows:
 - (a) Provision of a service involving the creation of an asset involving private sector design, construction, financing, maintenance and delivery of ancillary services for a specific period;
 - (b) A government agrees to provide land and capital works, risk sharing, revenue diversion, and the purchase of the agreed services or other supporting mechanisms; and
 - (c) The private sector receives payments from government (or users of economic infrastructure) once operation of the infrastructure has commenced and those payments are contingent on the private sector's performance in supplying the services.

- 5 These service concession arrangements take one of two main forms:
- (a) The State will pay the operator over the period of the arrangement, subject to specified performance criteria being met. At the date of commitment to the principal provisions of the arrangement, these estimated periodic payments are allocated between a component related to the design and construction or upgrading of the asset and components related to the ongoing operation and maintenance of the asset. These are known as ‘social service concession arrangements’ or ‘availability structures’
 - (b) The other form of service concession arrangement involves the State granting to the operator, for a specified period of time, the right to collect fees from users of the service concession asset, in return for which the operator constructs the asset and has the obligation to supply the agreed services, including the maintenance of the asset for the period of concession. These are referred to as ‘economic service concession arrangements’ or ‘user pay structures’
- 6 Because service concession arrangements involve the government as grantor and the private sector operator sharing the risks associated with the provision of public infrastructure assets, the degree of risk assumed by each party (and the nature of each party’s rights and obligations) may be different from service concession arrangement to service concession arrangement.
- 7 IFRIC 12 and IPSAS 32 distinguish between service concession arrangements based on whether the consideration promised in exchange for the construction, maintenance and operation services is a financial asset or an intangible asset.

The financial model

- 8 If the grantor promises availability payments in exchange for those services, the operator and the grantor will account for the service concession arrangement under the ‘financial model’. This means that as the grantor’s service concession asset is being created or enhanced, the grantor will recognise a financial liability to pay for the services performed. Consequently the accounting for this transaction is similar to the accounting for other service contracts with deferred payment terms. The service concession arrangement will also be accounted for under the financial model if, even though the grantor does not promise cash consideration in exchange for the construction and operations services, the grantor assumes the demand risk associated with the service concession asset.

The intangible model

- 9 The operator and the grantor will account for the service concession arrangement under the ‘intangible model’ if the grantor promises to grant the operator a right to charge users of the service concession asset (instead of making availability payments) and the operator is exposed demand risk associated with the service concession arrangement. In accounting for the intangible model from the grantor perspective, the issues to be resolved are:

- (a) the recognition and measurement of the service concession asset that is being created or enhanced, in particular whether the measurement of the asset should be adjusted to reflect the fact that the grantor has assigned the tolling rights for the asset to the operator (this issue is discussed in Agenda Paper 7.2); and
 - (b) whether the grantor should recognise revenue or a liability for a service concession asset arrangement in which it transfers to the operator a right to charge users of the service concession asset in exchange for the construction, maintenance and operation of a public infrastructure asset.
- 10 For the remainder of this paper, the analysis is limited to that of intangible model as it is fundamentally accepted that where the government is producing social infrastructure, the financial liability model would be adopted and government would recognise an asset and a liability relating to the service concession arrangement. However, in some places, the paper refers to the accounting under the financial model to illustrate the contrast between financial reporting outcomes.

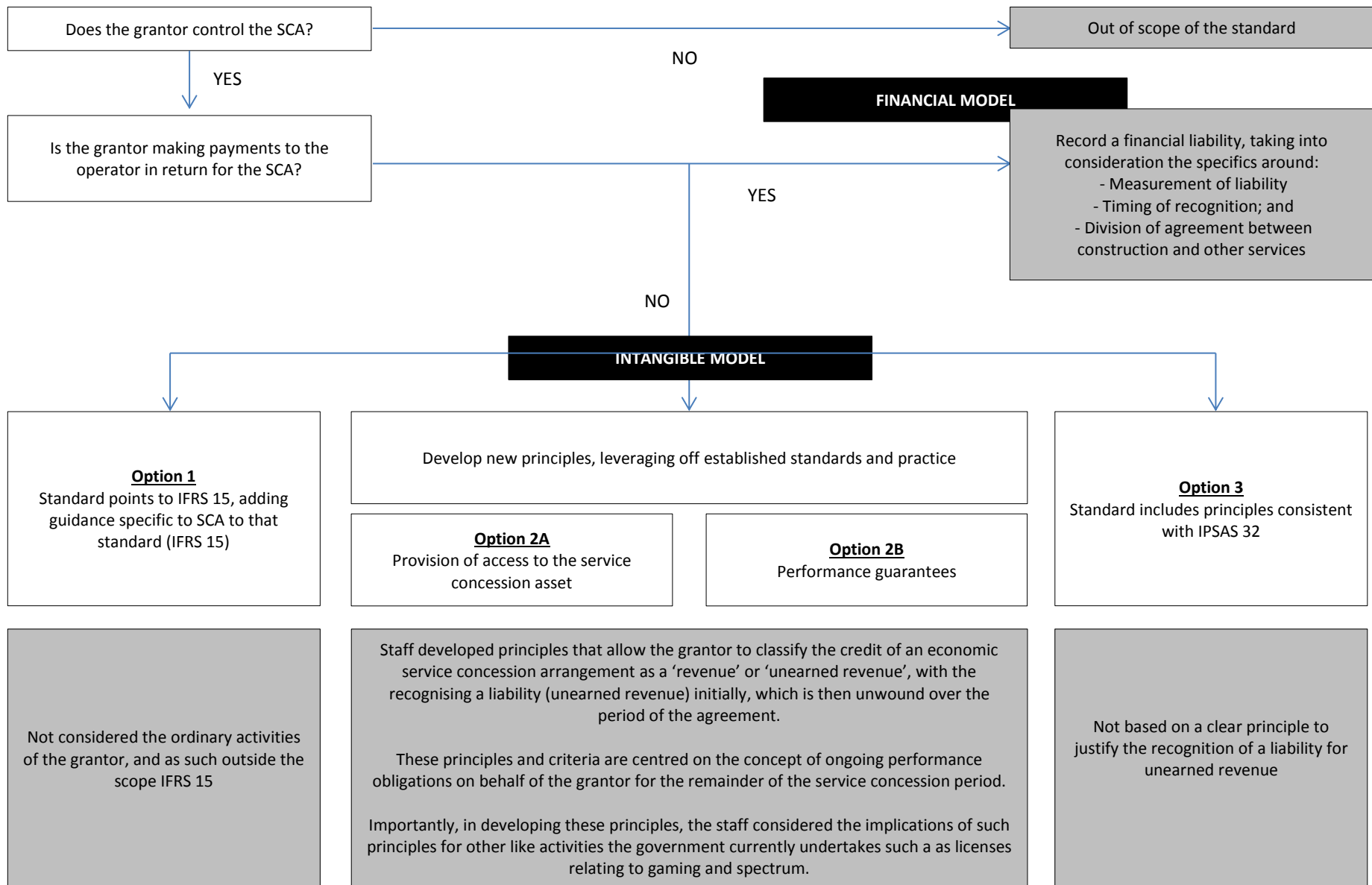
Issue

- 11 Typically, the intangible model involves the payment of tolls, fares or user charges for the use by the public or business entities of facilities such as roads, bridges, tunnels and potentially, ports, airports and trams. Generally, the revenue earned through the user charges is expected to be sufficient to enable the operator to repay the debt raised to fund construction of the facility, meet operating costs, pay the interest on the debt raised and give the required return on investment.
- 12 With respect to such infrastructure, there is divergence in opinion as to whether the provision of the license from the government should be considered the payment for the construction and operation of the service concession asset; or whether in this instance the grantor is acting as a supplier (providing a license to charge users) as well as a customer (receiving the construction and operation of as service concession asset). Furthermore, there are differing views as to whether the grantor has at the time of agreement has effectively performed all of its obligations under the contract in order to be entitled to the service concession asset.
- 13 While the answer to these questions will not significantly effect the total amount of revenue recognised over the life of the service concession arrangement, this will determine whether such revenue is recognised at the beginning of the contract, or if it recognised initially as a liability (unearned portion of revenue) that is un-wound over the period of the agreement as and when the grantor performs their ongoing activities against the agreement.
- 14 In a financial model, the grantor performs its obligations under the contract when it makes the availability payments to the operator, which typically are payments made during the operations phase of the service concession arrangement. Consequently, as the operator is constructing the service concession asset for the grantor, IPSAS 32 (and the Board's decisions to date) would require the grantor recognise both the service concession asset under construction and the corresponding financial liability to make availability payments in the future.

- 15 In contrast, under the intangible model, the issue to be resolved is whether the grantor performs its obligations when (or as) one of the following occurs:
- (a) the grantor transfers to the operator a licence (i.e. a right to charge users) in relation to the service concession asset;
 - (b) the grantor provides the operator access to the service concession asset over the life of a service concession arrangement; or
 - (c) the grantor guarantees the performance of the operator and, as such, the grantor will step-in to provide the public services if the operator fails to do so.

Prior AASB discussions

- 16 At the September 2014 AASB meeting, staff identified the following possible approaches for the progressing the accounting of economic service concession arrangements by grantors:
- (a) Approach 1: Proceed with IFRS 15 and supplement with guidance
 - (b) Approach 2: Modify IFRS 15
 - (c) Approach 3: Apply IPSAS 32
- 17 In response, the Board tentatively decided that, from a grantor's perspective, a service concession arrangement in which the grantor promises to transfer an intangible asset to the operator would not be a contract with a customer within the scope of IFRS 15.
- 18 The Board considered that the intangible asset the grantor promises to transfer to the operator in exchange for the operator's services is in the nature of a financing arrangement for the construction of the service concession asset and, as such, would not be an output of the government's ordinary activities.
- 19 In light of its tentative conclusion that, from a grantor's perspective, a service concession arrangement would not be a contract with a customer, the Board directed the staff to analyse alternatives other than IFRS 15 for accounting for a grantor's rights and obligations.
- 20 The Board noted that some aspects of IFRS 15 may not be particularly suitable for application to service concession arrangements, but other aspects could be suitable for application by analogy to a grantor's rights and obligations. In developing other alternatives, the Board directed the staff to consider aspects from other pronouncements, including IPSAS 32 *Service Concession Arrangements: Grantor*.
- 21 The following diagram depicts a decision tree for the recognition of a corresponding entry for service concession arrangements, focussing on the different options noted in paragraph 16 above, which then form the basis for the discussion in the remainder of the paper.



Options

Option 1: Transferring a licence to charge users

- 22 As noted above, the Board previously considered whether, from a grantor’s perspective, a service concession arrangement would be a contract with a customer that is within the scope of IFRS 15. The Board concluded that, from the grantor’s perspective, these arrangements were not contracts with customers because the licence to charge users of a service concession asset was not an output of the governments’ ordinary activities.

- 23 Notwithstanding that a service concession arrangement might be strictly outside the scope of IFRS 15, if the general principles in IFRS 15 were to be applied to the grantor’s rights and obligations in a service concession arrangement, the staff believe that IFRS 15 would account for the licence as a right such as a right to a future income stream embodied in the service concession asset. Because the licence/right relates to a tangible asset rather than intellectual property, the IFRS 15’s application guidance on licences would not be directly applicable (although its relevance is considered further in paragraphs 26-27 below).

- 24 Agenda paper 15.3 from the Board’s September 2014 meeting outlined the application of IFRS 15 to the licence as a right to a future income stream. The following analysis summarises how IFRS 15 would apply to the licence to charge users:

IFRS 15 steps	Analysis
Step 1: Identify the contract	The contract is the service concession arrangement
Step 2: Identify the separate performance obligations	<p>While each service concession arrangement is unique, the staff understands that, in many economic service concession arrangements, the licence to charge users of the service concession asset is the only good or service promised by the grantor to the operator. Consequently, for those contracts, there is only one performance obligation, which is the promise to transfer the licence.</p> <p>For service concession arrangements in which other goods or services are promised to the operator and those goods or services are distinct, the grantor will account those other promised goods or services as separate performance obligations and allocate transaction price to them (see Step 4 below).</p>

<p>Step 3: Determine the transaction price</p>	<p>The consideration promised by the operator is in a non-cash form—being the promise of services to construct, maintain and operate the service concession asset. The consideration promised only includes operations activities to the extent that those activities provide a service to the grantor. If those operations activities relate to the operator’s own performance (such as collecting the toll receipts), those activities do not provide a service to the grantor and therefore would not represent a component of the consideration promised by the operator.</p> <p>Under IFRS 15, the transaction price will be the fair value of the non-cash consideration received (eg the fair value of construction services, maintenance services and any operations services).</p>
<p>Step 4: Allocate the transaction price</p>	<p>If only one performance obligation has been identified in the contract, all the transaction price is allocated to that performance obligation.</p> <p>If there is more than one performance obligation, the transaction price will be allocated to each performance obligation on a relative stand-alone selling price basis.</p>
<p>Step 5: Recognise revenue when (or as) a performance obligation is satisfied</p>	<p>Because there is no ongoing performance by the grantor after the licence has transferred to the operator, staff expect that a grantor would satisfy its performance obligation at the time when the ‘right to charge users’ is transferred, which could be at contract inception. Staff consider that the operator obtains control of the ‘right to charge users’ at contract inception (or whenever the right is transferred to the operator) because the right is exclusive to the operator, and therefore, entitles the operator to deny other entities from accessing the future income stream relating to the specified service concession asset. The fact that the operator has not yet constructed the service concession asset and, therefore, would not receive payments from users of the asset for some time does not mean that control of the right to charge users has not transferred to the operator.</p>

- 25 This analysis indicates that applying the general principles of IFRS 15 to the transfer of a licence to charge user (which represents a right to a future income stream) would result in the grantor recognising ‘upfront’ revenue. This would represent a markedly different financial reporting outcome compared to a service concession arrangement in which the grantor promised availability payments instead of transferring a right to charge users. The reason for the different outcome is that, in an economic service concession arrangement, the grantor is, in effect, paying for a service concession asset with consideration in the form of a previously unrecognised asset (the right to charge users).

Option 2A: Provision of access to the service concession asset

- 26 Another view is that the grantor’s obligation in an economic service concession arrangement is, in effect, to provide the operator with a service of access to the service concession asset over the concession period. There are two ways in which this ‘service of access’ could be analysed.
- 27 The ‘service of access’ could be regarded as being akin to a lease, whereby the operator has the right to use the service concession asset over the term of the service concession arrangement and the operator will use that access to generate future cash flows (in the form of toll receipts). The problems with this view include:
- (a) IFRIC 12 has concluded that a service concession arrangement does not represent a lease¹
 - (b) The access to the service concession asset has been granted to the operator primarily for the purposes of providing the promised construction, maintenance and any operations services to the grantor. As noted in Agenda Paper 15.3 from September 2014 meeting, this is akin to the access that a customer would grant to a builder who is constructing a house on the customer’s land or to a cleaner who is cleaning the customer’s offices.
- 28 Alternatively, the ‘service of access’ in a service concession arrangement could be regarded as similar to licences of intellectual property in which notwithstanding that the licence (as a legal right or instrument) might transfer to the operator at a point in time, the licence represents the promise of access to the license. Fundamentally, this is a symptom of a situation in which the interests of the supplier (grantor) and operator (customer) are aligned, and there is an expectation that the customer will benefit from the activities undertaken by the supplier.
- 29 As indicated in Agenda Paper 8.3 from the July 2014 Board meeting, these criteria do not readily translate to service concession arrangements. Therefore, to the extent that the licence to charge users is regarded as being similar to licences of intellectual property, staff have identified a number of activities that are undertaken by grantors in relation to economic service concession arrangements. Based on discussions with the jurisdictions, these include (but are not limited to) a combination of the following depending on the agreement in hand:

¹ IFRIC 12 Service Concession Arrangements: paragraph B24, B27

- (a) The public sector entity may be obliged to consult with the private sector entity about the public infrastructure that is within the scope of the service concession arrangement if and when the public sector entity plans to undertake further improvements or expansions to the Government's roads network master plan. Even though the public sector entity may have an obligation to consult, the public sector entity may not be not restricted from developing another public road network and other public transport system.
- (b) The public sector entity may be obliged to, for example, renegotiate the term of the arrangement, the toll price and/or its financial or operational contribution to the arrangement, if the public sector entity undertakes activities that would cause material adverse effects on the private sector entity's collection of toll revenue, or the repayment of/on capital and debt issues. Examples of activities that would cause material adverse effects include implementing 'competing road projects' and interrupting traffic connections to the private sector entity's motorway.
- (c) The public sector entity may be obliged to assist the private sector entity in managing or facilitating traffic between connecting public arterial roads, freeways or other road networks and parts of the private sector entity's motorway, for example, in the event of accidents, approved lane closures on the motorway for repairs, and peak hour traffic.
- (d) The public sector entity (through the Government's road and transport authority) may be obliged to assist the private sector entity in identifying non-paying vehicles and in the collections of non-payment toll fares.
- (e) The public sector entity may be obliged to assist the private sector entity in liaising, managing relationships and resolving disputes involving other public sector entities, the private sector entity, stakeholders and the public during the course of the service concession arrangement, for example, dealing with a local council on the impact of construction or traffic on its precinct or suburbs.
- (f) The public sector entity may be entitled to a share of the tolled revenue if actual toll revenue is higher than the forecasted revenue.

30 Noting that these are effectively the breadth of different activities that a grantor might undertake as part of their role in a service concession arrangement, the following factors could be used as a base to determine whether the activities the grantor has to perform during the concession period are akin to the grantor having a remaining obligation relating to the provision of access to the service concession asset. The assessment will need to consider all relevant facts and circumstances and, as such, it may be more appropriate to present the factors as indicators rather than criteria that must be present.

The economic substance of the transaction would be lead to revenue being recognised immediately on exchange if the following criteria were met:

- a. The grantor is not required to consult with the operator on public infrastructure that is within the scope of the service concession agreement*
- b. The operator has full control of the pricing of services provided to third parties in the service concession arrangements*
- c. The grantor has no on-going role in the management or the service concession arrangement*
- d. There is no expectation that the grantor will influence the third parties in their use of the service concession asset;*
- e. The grantor is not entitled to a share of revenue beyond that forecasted in the service concession arrangement*

The examples and indicators in paragraph X are not always conclusive. If it is clear from other features of the service concession agreement that the grantor is undertaking significant ongoing activities in relation to the service concession agreement, a liability should be recognised for the unearned portion of revenue relating to the agreement.

Where the indicators in paragraph X are not present, the grantor does not recognise revenue from the exchange immediately. Instead, a liability is recognised for any portion of the revenue that is not yet earned. The revenue is then recognised according to the economic substance of the service concession arrangement, and the liability is reduced as revenue is recognised.

To the extent that the grantor recognises a liability, it shall recognise revenue and reduce the liability recognised in accordance with paragraph X according to the economic substance of the service concession arrangement.

- 31 Therefore, if a grantor has promised an operator a ‘service of access’ in a service concession arrangement, the staff expects that the grantor would recognise the promised consideration as revenue as that access is provided over the term of the service concession arrangement. If the general principles of IFRS 15 were also to apply and another performance obligation was identified, the promised consideration would need to be allocated between the ‘service of access’ and any other goods or services promised in the contract.
- 32 There are two potential risks in adopting this approach would be around the comparability of financial reports. These factors are relatively broad, and consequently there is potentially scope for a practitioner to justify either the recognition of revenue or unearned revenue (liability) in some instances. The other – being the risk that practitioners may try to apply this by analogy to other licenses is addressed in ‘other considerations’ below.

Option 2B: Performance guarantees

- 33 Some commentators have suggested that a grantor typically provides an explicit or implicit performance guarantee in a service concession arrangement because the government retains overall responsibility for providing public services. Accordingly, if the operator fails to perform as promised, the government would be required to step-in and provide those public services directly or identify another party that could replace the previous operator. As such, those commentators would question whether the government has fulfilled all of its obligations until the agreement is completed.
- 34 That view could be regarded as being consistent with reasons that have been put forward to explain why governments enter into service concession agreements. For example, The National Public Private Partnership Guidelines states: *Australian governments are committed to investing infrastructure and delivering improved services to the community. Infrastructure investment is critical to our economic prosperity, and governments across jurisdictions currently seek the participation of the private sector in the delivery of infrastructure and related services to the public*².
- 35 However, the staff thinks that this view may confuse the relationship between the government's responsibility to provide public services and the government's rights and obligations in a service concession arrangement. In effect, the government is using the service concession arrangement to engage the private sector to provide public services on its behalf. In that regard, the government is akin to a prime contractor because the government retains overall responsibility for providing public services and the operator is akin to the subcontractor that provides services to the prime contractor. Therefore, consistent with other contractual relationships between prime contractors and subcontractors, any obligation that the prime contractor might have to guarantee the performance of its subcontractor is indistinguishable from its general obligation (or responsibility) to provide the public services. Given that governments do not recognise an obligation for their responsibility to provide public services, the staff thinks that there is no basis to recognise that obligation only in those cases where the government has chosen a private sector entity to provide those public services on its behalf. Consequently, the staff thinks that the identification of a performance guarantee in a service concession arrangement would not provide justification for the recognition of a liability.

Option 3: Apply IPSAS 32

- 36 Although the adoption of IPSAS 32 may provide a pragmatic accounting treatment for service concession assets; and is consistent with the concept that service concession arrangements are unique transactions (as discussed in Agenda Paper 7.2), it was a general consensus from the Board that the IPSAS 32 requirement to recognise a liability lacked a conceptual basis. An excerpt of the basis of conclusions from IPSAS 32 on this item is found at *Attachment A*.
- 37 Aside from the concerns raised about the lack of a conceptual basis, the staff note that applying IPSAS 32's requirement for the recognition of a liability would achieve a uniform accounting treatment for all economic service concession arrangements notwithstanding that each service concession arrangement might have some unique

² National Public Private Partnership Guidelines – Overview, Infrastructure Australia, page 1

features. For that reason, some of the other options considered in this paper might provide for a more faithful representation of the rights and obligations of a service concession arrangement.

Other government licences

- 38 Under both Option 2A and Option 2B, it would be important to scope this appropriately so as to delineate with other license arrangements that the government offer. The service concession arrangement principles must contrast with gambling and spectrum licenses because the governments activities in those cases are in the nature of ensuring that the government has transferred what was promised. Therefore activities to stop competing illegal gambling operations or to monitor spectrum interference is akin to defence of patents, which is addressed in IFRS 15 as follows:

An entity shall disregard the following factors when determining whether a license provides a right to access the entity's intellectual property or a right to use the entity's intellectual property:

- a. Restrictions of time, geographical region or use – those restrictions define the attributes of the promised license, rather than define whether the entity satisfies its performance obligation at a point in time.*
- b. Guarantees provided by the entity that it has a valid patent to intellectual property and that it will defend that patent from unauthorised use – a promise to defence a patent right is not a performance obligation because the act of defending a patent protects the value of the entity's intellectual property assets and provides assurance to the customer that the license transferred meets the specifications of the license promised in the contract.*

- 39 As such, to the extent that the Board agree to progress under either of these options, it may be worth including some guidance along these lines in the proposed standard to limit the analogous interpretation.

Staff recommendation

- 40 As discussed above, the attempted application of IFRS 15 to service concession arrangements for grantors did not hold. Further, as evidenced by Agenda Paper 7.2, the IASB and IPSASB consider service concession arrangements to be sufficiently different to other licences to warrant separate guidance from general revenue requirements – a view which is supported by practitioners. Further, it is generally agreed that the solution offered by IPSAS 32 application is not based on a solid conceptual basis, and the adoption of a 'performance guarantee' assessment is likely to provide an unsatisfactory result for standard setters and practitioners alike.
- 41 Accordingly, staff recommend that the principles in paragraph 30 are adopted as they provide a principles based response with a practical answer.
- 42 While there is risk in developing new principles (i.e. that grantors may wish to apply these requirements by analogy to other licenses in order to prevent up-front recognition of revenue), this can be alleviated with guidance along the lines of what is proposed in the section on other considerations detailed above.

Question 1 to the Board

Does the Board agree with the staff recommendation in paragraph 41 above relating to the development of principles on the recognition of revenue for economic service concession assets?

Attachment A

- BC18. ED 43 proposed that when the grantor recognizes a service concession asset, a liability shall also be recognized. The ED noted that this liability may be any combination of a financial liability and a performance obligation. ED 43 proposed that a financial liability occurs when the grantor has a determinable series of cash payments of cash or cash equivalents to make to the operator and a performance obligation occurs when the grantor compensates the operator by granting the operator the right to charge users of the service concession asset or by granting the operator access to another revenue generating asset for its use. ED 43 proposed that the grantor account for the performance obligation in accordance with IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets.
- BC19. Respondents to ED 43 sought clarification on this issue, particularly with respect to the **“performance obligation” identified in ED 43. Respondents’ concerns are summarized below.**
- (a) The right to charge users of the service concession asset or by granting the operator access to another revenue-generating asset was seen by some respondents as independent of the compensation for the asset. These respondents highlighted that the requirement to provide access is a feature of most service concession arrangements, and if this is to be recognized, such recognition should not be dependent on the non-occurrence of a payment stream from the grantor to the operator.
 - (b) While being described as a performance obligation, there is no obligation for an outflow of economic resources from the grantor in future periods. These respondents therefore question whether a liability as defined in IPSAS 1, or a provision as defined in IPSAS 19 could be fairly represented to exist.
- BC20. In addition, a number of other respondents, possibly as a result of the above concerns, requested clarification **of the meaning of “performance obligation” in the ED. A few of these respondents queried whether the substance of the nature of this “balancing item” was deferred revenue.**
- BC21. The IPSASB agreed that clarification of this issue was required. The IPSASB noted that using **the term “performance obligation” could give rise to confusion because it is used in IPSAS 23, Revenue from Non-Exchange Transactions (Taxes and Transfers)** in relation to non-exchange transactions. The IPSASB noted that a service concession arrangement is an exchange transaction rather than a non-exchange transaction and therefore it would be preferable not to use the term performance obligation in relation to exchange transactions.
- BC22. In IFRIC 12, when the operator does not control the service concession asset, the operator recognizes either a financial asset, or an intangible asset, depending on which party bears the demand risk. The IPSASB agreed that, to maintain symmetry with IFRIC 12, the same approach should be adopted for the grantor. Thus, two models are identified for accounting for the credit when the grantor recognizes a service concession asset in accordance with this Standard: the financial liability model, and the grant of a right to the operator model (which replaces the **“performance obligation”**).
- BC23. **The IPSASB’s decision to amend the terminology used in ED 43 from “performance obligation” to the Standard’s use of “liability” does not change the grantor’s accounting treatment of a service concession arrangement from that proposed in ED 43.**