Accounting considerations

DRAFT

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Auckland LIGHT RAIL
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Accounting considerations - Overview

How to read this Appendix

We note that this Appendix does not constitute an accounting opinion on the proposed structures and set of arrangements between the parties, as the details have yet to be drafted or discussed between the parties. Instead, we have aimed to identify the critical points to consider from the perspective of the Sponsors (the Crown and Auckland Council) and from that of the Delivery Entity itself of the proposed alternative structures.

It is important to note that while we focused on high-level considerations, the terms of the legal arrangements, and any relevant legislation will need to be carefully considered to determine the appropriate accounting treatment.

This is because the accounting treatment follows the substance of the arrangement rather than its legal form. For example, even if the Delivery Entity has a legal form of an Incorporated Joint Venture, it will only be treated as such from an accounting perspective, if it meets the specific criteria in the relevant accounting standard.

This Appendix contains the following:

- *High level accounting considerations* related to the control of the Delivery Entity, accounting for the funding of the Delivery Entity and the transfer of the infrastructure assets to the Sponsors; and
- *High level accounting considerations* related to the short list of Contracting Models identified for the procurement of the Project infrastructure assets.

Applicable accounting standards

The parties to the proposed arrangement (Crown, Auckland Council etc) are Public Sector Public Benefit Entities for accounting purposes and apply Tier 1 Public Sector PBE Standards. We have also assumed that the Delivery Entity will be a Public Sector Public Benefit Entity given its primary purpose will be to deliver (and potentially operate) a public infrastructure asset.

Therefore to determine the likely accounting treatment for the proposed arrangement for the delivery of the Auckland Light Rail, we have considered Tier 1 PBE Standards.

Responsibility and Restrictions

The ultimate responsibility for the decision on the appropriate application of generally accepted accounting practice in relation to the Auckland Light Rail delivery and operation rests with the management of the respective parties to the arrangements.

Our advice has been based solely on the documentation, assumptions and representations provided to us as set out in this report. Should any of these alter, the legal documents entered into between the parties change from the terms advised to us, or if there are any other arrangements between the parties pertinent to the accounting treatment of which we haven't been advised, our conclusions may change. Our advice could be affected by the issue of future applicable financial reporting standards, or by future legislation or regulations. We do not take responsibility for advising you of changes in our views as a result of such developments subsequent to the date of this report.

This report has been prepared for the management of the parties to this engagement for their sole purposes. It should not be used or relied upon by any other person for any purpose, and we specifically disclaim responsibility to any other party for reliance on the contents thereof. The report should not be released to any third party, without our prior written consent.

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Accounting considerations - Delivery Entity

<table>
<tr><th>Area</th><th>Key Considerations</th></tr>
<tr><td>Nature of the Sponsors' interest in the Delivery Entity (DE)</td><td>The Sponsors will need to determine the nature of their interest in the DE.
• If one of the Sponsors controls the DE (or silos of the DE), it would have to consolidate it (or the silo) resulting in the DE's income and expenses, assets and liabilities, including its debt (or portion thereof) coming onto the consolidated balance sheet of that Sponsor.
• If a Sponsor has significant influence (associate) or joint control of the DE, their investment in the DE would be equity accounted for (if the joint arrangement is a 'joint venture'). A 'joint venture' is where the parties have rights and interests to the net assets of the arrangement. The venturers' investment is equity accounted (their investment in the joint venture is presented as a single line in the balance sheet).
• If the DE is a joint operation, each Sponsor would recognise its share of income / expenses and assets / liabilities of the DE. A joint operation is whereby the parties that have rights to the assets, and obligations for the liabilities, relating to the arrangement.
• A Sponsor would account for an investment in the DE as a financial asset measured at fair value if it is determined that they have no control/joint control or significant influence of the DE.
Accounting 'control' and 'joint operation' outcomes at Sponsor level should be avoided if the Sponsors want to ensure that the DE's debt (or a portion of its debt) does not come onto either of the Sponsors' balance sheet.
Using CRLL as an example, the Sponsors currently account for their interest in CRLL as a 'joint venture' (as the ultimate ownership of the CRL assets is yet to be determined). Therefore each of the Sponsors equity account for their interest in CRLL (their investment in the joint venture is presented on a single line in the balance sheet). If and when the ultimate ownership of the assets delivered by CRLL are determined, the Sponsors' investment in CRLL may be reclassified as a joint operation.</td></tr>
<tr><td>Funding provided to the DE</td><td>The Sponsors will need to determine the accounting treatment for the funding provided to the DE. The accounting for the funding will have to be determined based on contractual terms.
Project finance ring fencing should be applied to ensure that the Sponsors have no unavoidable obligation to provide additional funding which would result in the recognition of a financial liability in their financial statements (in addition to their accounting for their investment in the DE).
The proportion of funding provided by the Sponsors in itself, does not determine the nature of the Sponsors interest in the DE (e.g. whether they have control or joint control etc.). However, if one party assumes substantially more of the significant risks with the DE's assets and its funding, that may lead some to question whether that party controls the DE. Nevertheless, as long as the parties continue to make unanimous decisions about the relevant activities of the DE, the nature of their investment in the DE would likely be a 'joint arrangement'.
Using CRLL as an example, the Sponsors co-fund CRLL in equal amounts by way of subscription to shares of CRLL. Funding provided to CRLL is accounted for as an increase in the Sponsors equity accounted investment in CRLL. Undrawn funding commitment of the Sponsors is not recognised as a liability (but disclosed as a contingent liability). In the financial statements of CRLL, the funding provided to CRLL is accounted for as an equity contribution from CRLL's owners, the Sponsors.</td></tr>
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Accounting considerations - Delivery Entity

<table>
<tr><th>Area</th><th>Key Considerations</th></tr>
<tr><td>Who controls the Project transport infrastructure as it is constructed?</td><td>Even if the Project transport infrastructure assets will be transferred to the operating entity when construction is completed, the accounting treatment will depend, at least in part, on whether the Sponsors (or if different, the ultimate recipient of those assets) controls the infrastructure assets on completion or as the assets are constructed. If the Sponsors, rather than the DE, controls the assets during construction, the DE will recognise an expense and the Sponsors will recognise income and PPE as the assets are constructed rather than on completion.

If the Sponsors want to reduce the risk that the Project infrastructure is recognised on their balance sheet during construction rather than on completion, the DE would have to take on significant risks associated with the assets and their funding during that period.

The legal terms of the arrangement need to be carefully considered.

Using a Schedule 4A (S4A) company as an example:

• If the S4A will not be responsible for operations and the Project infrastructure assets will be transferred to the operating entity when construction is completed, the accounting treatment will depend, at least in part, on whether the Sponsors (or if different, the ultimate recipient of those assets) controls the infrastructure assets on completion or as the assets are constructed. If the Sponsors, rather than the S4A controls the assets during construction, the S4A will recognise an expense and the Sponsors will recognise income and PPE as the assets are constructed rather than on completion.

• If the S4A will be responsible for operating Project infrastructure assets, it would need to be considered, whether the S4A controls the assets throughout their construction and following completion. If the assets are ultimately transferred to the Sponsors (e.g. following a period of operation by S4A), it would have to be considered whether the arrangement contains a service concession arrangement or an in substance lease of the Project infrastructure assets from the Sponsors during the period of the operation.

CRLL currently accounts for the CRL assets as its own 'Capital Work in Progress' as those are being constructed as CRLL is considered to control those assets while they are being constructed.</td></tr>
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Accounting considerations - Delivery Entity

Area	Key Considerations
Transfer of the assets	The recipient of the assets delivered by the DE will need to determine the accounting treatment for the receipt of the assets. If the assets are transferred to the Sponsors, (and unless the assets are transferred as a distribution or return of capital (through equity): • The Sponsors would recognise income and PPE WIP as the assets are constructed; or on completion. • Assuming the assets are transferred to the Sponsors for no or nominal consideration, the Sponsors would recognise PPE at fair value and a corresponding income. *Assuming the DE will not undertake operations:* • *If the DE controls the assets during construction, it would have to determine whether the transfer of those assets is accounted for as a distribution or return of capital (through equity) or as a vested asset (through surplus or deficit). This determination will be influenced by the funding structure of the DE and the identity of the recipient of the completed assets.* • *If the DE does not control the assets during construction, it will recognise an expense and the Sponsors will recognise income and PPE as the assets are constructed rather than on completion.*
Accounting for the Project assets by the recipients post-asset transfer	The recipient of the assets delivered by the DE will need to determine the accounting treatment for the assets. If the recipient of the assets have existing accounting policies and estimated useful lives for the same classes of infrastructure assets, those existing accounting policies and estimates related to existing asset classes are expected to apply to the Project assets. If the recipient under existing accounting policies measures existing infrastructure assets at fair value, the assets received will also have to be revalued periodically in accordance with those existing accounting policies. The recipient(s) would have to start recognising depreciation when the assets become available for use. Therefore whether the assets are recognised by the recipient(s) as they are being constructed or on completion does not impact on the timing and the amount of the depreciation recognised by the recipient(s). Depreciation of the assets will likely have to be funded by the recipient(s) on a similar basis to the depreciation of assets constructed by the recipient(s) themselves. *For example:* • *If the recipient(s) of assets have existing accounting policies and estimated useful lives for the same class of infrastructure assets, it would have to apply those existing accounting policies and estimates related to the Project assets received. The recipient(s) would have to start recognising depreciation when the assets become available for use.* • *If the DE will control the Project infrastructure assets during construction and following completion, it may not have existing accounting policies related to similar assets and will have to develop its accounting policies related to the assets received; and it will have to start recognising depreciation when those assets become available for use.*

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Accounting for interests in another entity - key concepts referred to in this Appendix

When does an entity control another entity?

An entity **controls** another entity when the entity is exposed, or has rights, to variable benefits from its involvement with the other entity and has the ability to affect the nature or amount of those benefits through its power over the other entity (PBE IPSAS 35.14).

Power consists of existing rights that give the current ability to direct the relevant activities of another entity, being the activities that significantly affect the nature or amount of the benefits that an entity receives from its involvement with that other entity.

An entity can have power over an entity by virtue of its involvement in the entity's purpose and design, such that it has exercised its power in predetermining the entity's relevant activities to ensure that the significant benefits from those activities will flow to it and not others (PBE IPSAS 35 AG8.1).

If an entity controls another entity, it would have to consolidate it resulting in the investee's income and expenses, assets and liabilities, including its debt coming onto the investor's consolidated balance sheet.

Silos - Specific assets and liabilities of an entity might be ring-fenced from its other assets and liabilities. This type of arrangement can exist within a legal entity and is referred to as a 'silo'. Where specific conditions are met, the silo is deemed a separate entity and therefore the investor(s) in the silo would have to assess whether it has control of the silo rather than assessing control at the level of the broader legal entity. If it is concluded that the investor has control, it should consolidate the silo. The other investors in the entity then will have to exclude that portion of the SPV in their own assessment of control (PBE IPSAS 35 AG78-81).

Joint arrangements / Joint control

A **joint arrangement** is an arrangement of which two or more parties have joint control. Joint control is the agreed sharing of control of an arrangement by way of a binding arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control (PBE IPSAS 37.7). There are two types of joint arrangements:

- **A joint operation** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. If the joint arrangement is a joint operation, each venturer would recognise its share of income/expenses and assets/liabilities of the joint operation.
- **A joint venture** is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. If the joint arrangement is a joint venture, the venturers' investment in the joint venture would be equity accounted for such that their investment in the joint venture is presented on a single line in the balance sheet. The investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets of the joint venture.

Associates / Significant influence

An **associate** is an entity over which the investor has significant influence. Significant influence is the power to participate in the financial and operating policy decisions of another entity but is not control or joint control of those policies (PBE IPSAS 36.8).

Whether an investor has **significant influence** over the investee is a matter of judgement based on the nature of the relationship between the investor and the investee, and on the definition of significant influence. If an entity holds a quantifiable ownership interest and it holds, directly or indirectly (e.g., through controlled entities), 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the entity holds, directly or indirectly, less than 20% of the voting power of the investee, it is presumed that the entity does not have significant influence, unless such influence can be clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an entity from having significant influence.

If an investor has significant influence of the investee, its investment would be equity accounted for as described above in respect of joint venture accounting.

Financial asset

An investor would account for an investment in an entity as a financial asset in accordance with PBE IFRS 9 Financial Instruments measured at fair value if it is determined that it does not have control/joint control or significant influence of the investee.

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