Joint Arrangements: What's new under IFRS 11?

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Abstract

In May 2011, the International Accounting Standards Board (IASB) issued a set of new International Financial Reporting Standards (IFRS) which are effective for annual periods beginning on or after 1 January 2013: (i) IFRS 10 - *Consolidated Financial Statements*, (ii) IFRS 11 - *Joint Arrangements* and (iii) IFRS 12 - *Disclosure of Interests in Other Entities*.

The European Union (Regulation No 1254/2012) endorsed these standards and it has established that each company shall apply them, at the latest, as from the commencement date of its first financial year starting on or after 1 January 2014.

In particular, this paper focus the attention on the new requirements established by IFRS 11. This new standard supersedes IAS 31 - *Interests in Joint Ventures* and SIC-13 *JointlyControlled Entities – Non-Monetary Contributionsby Venturers*, in order to arrive at an accounting treatment which accurately reflects the true nature of the economic interest held by parties to a joint arrangement.

By issuing IFRS 11, the IASB introduced an overhaul of the existing accounting for joint arrangements. In this regard, Management should carefully evaluate the new requirements, as they may have a significant impact on how an entity can present its income statement and balance sheet.

This paper - that is a part of a bigger project - aims to analyse the new criteria established under IFRS 11 and to highlight what are, at this stage, the main "critical points" that companies will face by applying the new standard.

Introduction and research questions

Joint ventures and alliances are an important form of international co-operation. In fact, in order to achieve economic goals, joint ventures have gained international importance in recent years (Stockinger et al., 2014).

The accounting for interests in joint ventures and alliances, when they are governed by joint control, was formerly covered by IAS 31. The accounting driver of that standard was the structure of the arrangements and, when those were structured in an entity, IAS 31 allowed preparers to have an accounting option. About half of the preparers with an interest in a jointly controlled entity apply the equity method; whereas the other half applying proportionate consolidation (IASB, 2011).

Because of this diversity, in May 2011 IASB introduced IFRS 11; this new standard (effective within the EU for annual periods beginning on or after 1 January 2014) replaces the previously guidance provided by IAS 31 and SIC 13.

IFRS 11 establishes the new framework for the accounting for joint arrangements, in which the parties recognise their rights and obligations relating to the arrangements. By so

doing, this new framework mainly aims to: (i) capture the economic substance of the arrangements and (ii) enhance comparability of financial statements.

The innovations established under IFRS 11 mainly regard two aspects: (i) the classification (and the accounting requirements) now focus on rights and obligations of the parties as criteria for demarcation between joint operations and joint ventures; (ii) the accounting option for joint ventures has been eliminated, consequently all joint ventures have to be recorded in the consolidated financial statements using the equity method (IFRS 11.24).

The new accounting requirements established under IFRS 11 and the need to investigate its potential impact on the financial statements, raise the following research questions:

- why IASB introduced IFRS 11?
- what are the main differences between the accounting requirements for joint arrangements under IAS 31 and those established under IFRS 11?
- what are the potential effects upon the financial statements of those prepares that are affected by the changes?

Since IFRS 11 has not been applied yet (as just mentioned it's effective for years beginning on or after 1 January 2014), no empirical researches are now possible. Therefore the aim of this paper, at this stage, is to analyse the main changes introduced by this new standard in order to highlight the main implications and the potential business impact that may arise from its application.

Having said that, the paradigm underlying our research, at this stage, is a qualitative one and it is divided into several steps: the first one is focused on an overview which highlights the reasons in issuing IFRS 11 and the weaknesses of IAS 31; the second one provides several definitions in order to understand the new meaning of joint arrangements in accordance with IFRS 11 and it also explains the new accounting requirements for joint operations and joint ventures; lastly the paper points out the main implications that may arise from this new standard (including its business impact).

Literature review

Not many academic contributions have focused on the International Accounting Standards issued by IASB (IAS 31 and IFRS 11). In particular, some of these papers have analysed, mainly from a theoretical/qualitative point of view, the scope and the new accounting treatments for joint arrangements underlying IFRS 11 (Mazzeo and De Gennaro, 2012; Vergani, 2011).

Moreover some authors, from a theoretical and practical point of view, have analysed the new standard (including the reasons that has led to the transition from IAS 31 to IFRS 11). They highlight the new features of joint arrangements under IFRS 11, also providing some examples of practical applications with reference to the representation of joint arrangements in the financial statements (Quagli, 2011; Mazzeo and De Gennaro, 2011).

In this context, we found out just a paper which provides an empirical study with reference to the impact of IFRS 11 on European companies. In particular, this paper examines how the transition from the proportionate consolidation method to the equity method (for the accounting of joint ventures) will affect financial statement figures and key financial ratios of these European companies (Stockinger et al., 2014).

Lastly, important points of reference are, of course, the standards issued by IASB (IAS 31; IFRS 11) and several practical guides focused on the business impact of IFRS 11 (Deloitte, 2011; E&Y, 2011; IASB, 2011; PwC, 2011).

The weaknesses of IAS 31 and the improvements of IFRS 11

IFRS 11, as mentioned above, was issued by IASB in May 2011. This new standard (which supersedes IAS 31 and SIC-13) establishes principles for the financial reporting by parties to a joint arrangement.

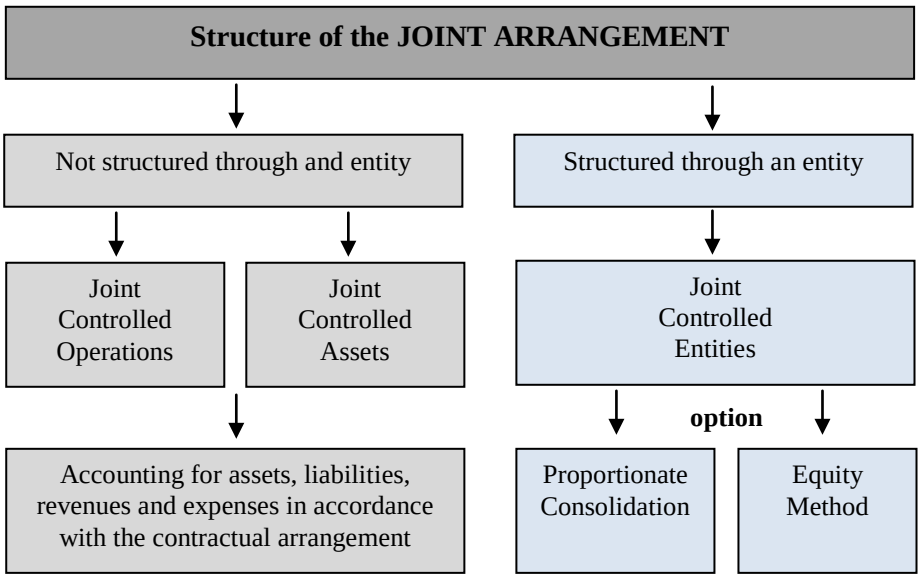
When the IASB undertook the project of reviewing IAS 31, it was concerned with remedying two aspects (or "weaknesses") of IAS 31 that were considered impediments to high quality reporting of joint arrangement: **(1)** the structure of the arrangement was the only driver for the accounting; **(2)** the accounting option for jointly controlled entities.

With reference to the first aspect, the accounting requirements in IAS 31 may not have always reflected the rights and obligations of the parties arising from the arrangement in which they were involved. These issues are solved by IFRS 11 because the identification, classification criteria and accounting requirements now focus on rights and obligations of the joint arrangement in which the parties are involved.

Moreover, with reference to the second point, IAS 31 gave a choice to apply either proportionate consolidation or the equity method for the accounting of jointly controlled entities. With the goal to reduce differences between IFRS and US-GAAP (United States-Generally Accepted Accounting Principles) and to improve the comparability of IFRS reports, the IASB eliminated the accounting option for joint ventures in IFRS 11 (which means that the proportionate consolidation method for joint ventures is now prohibited).

To bring to an end, we could say that the structure of the arrangement (which was the only driver for the accounting) and the existence of an accounting option for jointly controlled entities in IAS 31 resulted in inconsistencies in the accounting provided by IAS 31.

Figure n.1: The weaknesses of IAS 31



Source: our adaptation from IASB, 2011

IFRS 11 is an improvement of IAS 31 because it establishes a clear principle which is applicable to the accounting for all joint arrangements. In fact, in accordance with IFRS 11, a party to a joint arrangement recognises its rights and obligations arising from the arrangement (IFRS 11.IN5). By virtue of the application of this principle, IFRS 11 tries to achieve the following goals:

- enhances verifiability and understandability because the accounting reflects more faithfully the economic phenomena that it purports to represent (i.e. a party's rights and obligations arising from the arrangements);
- enhances consistency because it provides the same accounting outcome for each type of joint arrangement; and
- increases comparability among financial statements because it will enable users to identify and understand similarities in, and differences between, similar arrangements (IASB, 2011).

Joint arrangements, joint control and relevant activities

A joint arrangement is an agreement where two, or more parties, have joint control. A joint arrangement as the following characteristics: (a) the parties are bound by a contractual arrangement; (b) the contractual arrangement gives two or more of those parties joint control of the arrangement (IFRS 11.5).

Since the crucial element of having a joint arrangement is joint control, it is important to understand this term. Joint control is defined as the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities (activities that significantly affect the returns of the arrangement) require the unanimous consent of the parties sharing control (IFRS 11.IN 6). A party to an arrangement shall assess whether the contractual arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the relevant activities (IFRS 11.8).

Moreover, in accordance with IFRS 11, it is important to note that an arrangement can be a joint arrangement even though not all of its parties have joint control of the arrangement because this standard distinguishes between parties that have joint control of a joint arrangement and parties that participate in, but do not have joint control of, a joint arrangement. This means that, in order to have a joint arrangement, it is necessary that just two, of all the participants to an agreement, share joint control. At the same time, if one party can control unilaterally the relevant activities of the arrangement, then that agreement would not be a joint arrangement (in a joint arrangement, no single party controls the arrangement on its own).

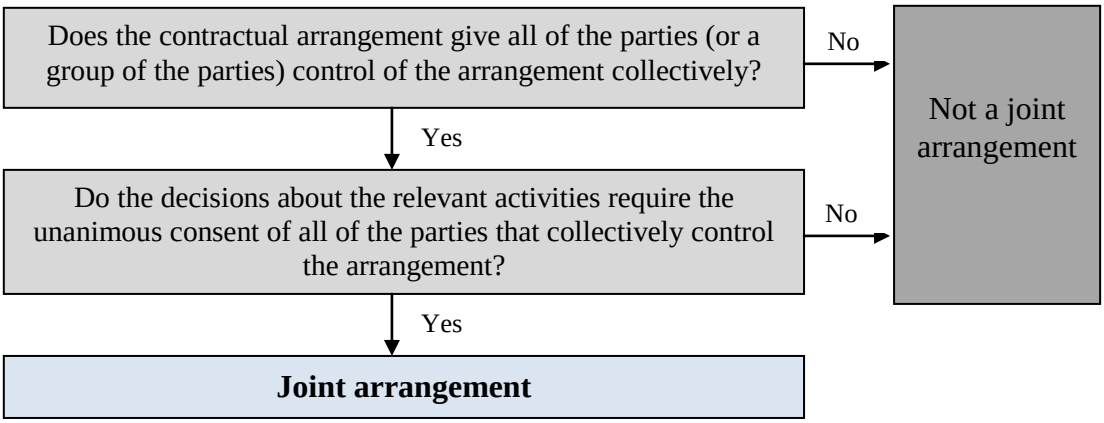
Therefore, the key aspects of joint control are:

- contractually agreed;
- control and relevant activities: IFRS 10 describes how to assess whether a party has control, and how to identify the relevant activities. In general, relevant activities are defined as those activities that affect significantly the return of an arrangement. Examples of these activities are: selling and purchasing of goods and services; selecting, acquiring or disposing of assets; managing financial assets during their life; researching and developing new products or processes and determining a funding structure or obtaining funding. Even though the term "relevant activities" may be broadly interpreted, it is well understood that it can be aligned to the concept of "financial and operational decisions" of a joint arrangement of IAS 31;
- unanimous consent: unanimous consent means that any party (with joint control) can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent.

Having said that, Management should accurately re-examine joint arrangements and re-consider whether they have joint control, control or neither of these. In fact, the change in

definition of "joint arrangement" and of "control" may include or exclude different arrangements compared to the past.

Figure n.2: How to evaluate if joint control exists



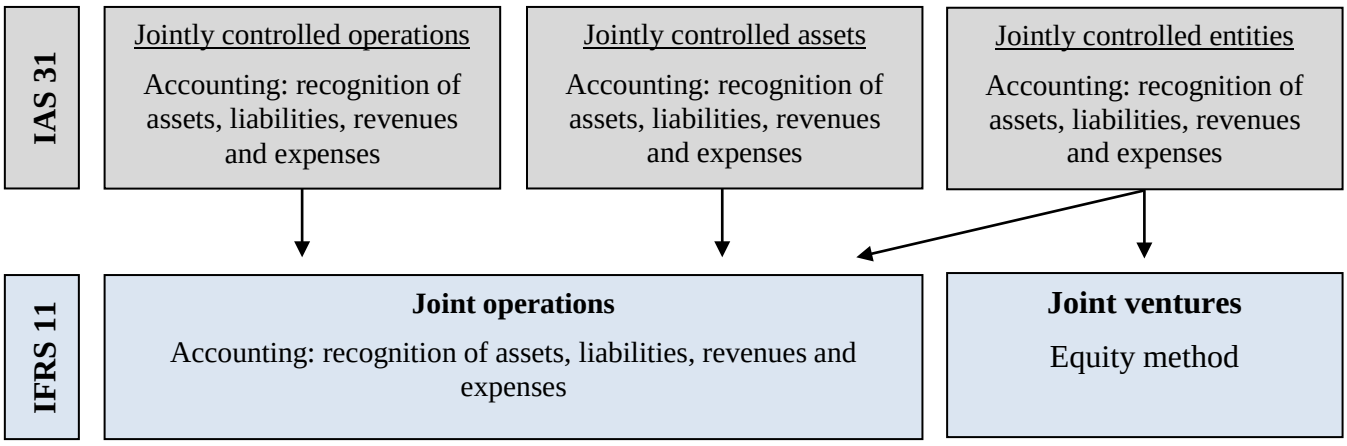
Source: E&Y, 2011

Types of joint arrangement

IFRS 11 introduces only two types of joint arrangements, compared with IAS 31. These joint arrangements are: **(a) joint operations**; and **(b) joint ventures**.

Therefore, under IAS 31, joint ventures included jointly controlled entities, jointly controlled assets and jointly controlled operations, whereas under IFRS 11 a joint venture is only one type of joint arrangement. 'Jointly controlled assets' and 'jointly controlled operations' (as defined under IAS 31), are likely to qualify as joint operations under IFRS 11, but each arrangement will need to be assessed to confirm this presumption. On the other side, 'Jointly controlled entities' under IAS 31, may be joint operations or joint ventures under IFRS 11, depending on the rights and obligations of the parties to the joint arrangement.

Figure n. 3: From IAS 31 to IFRS 11



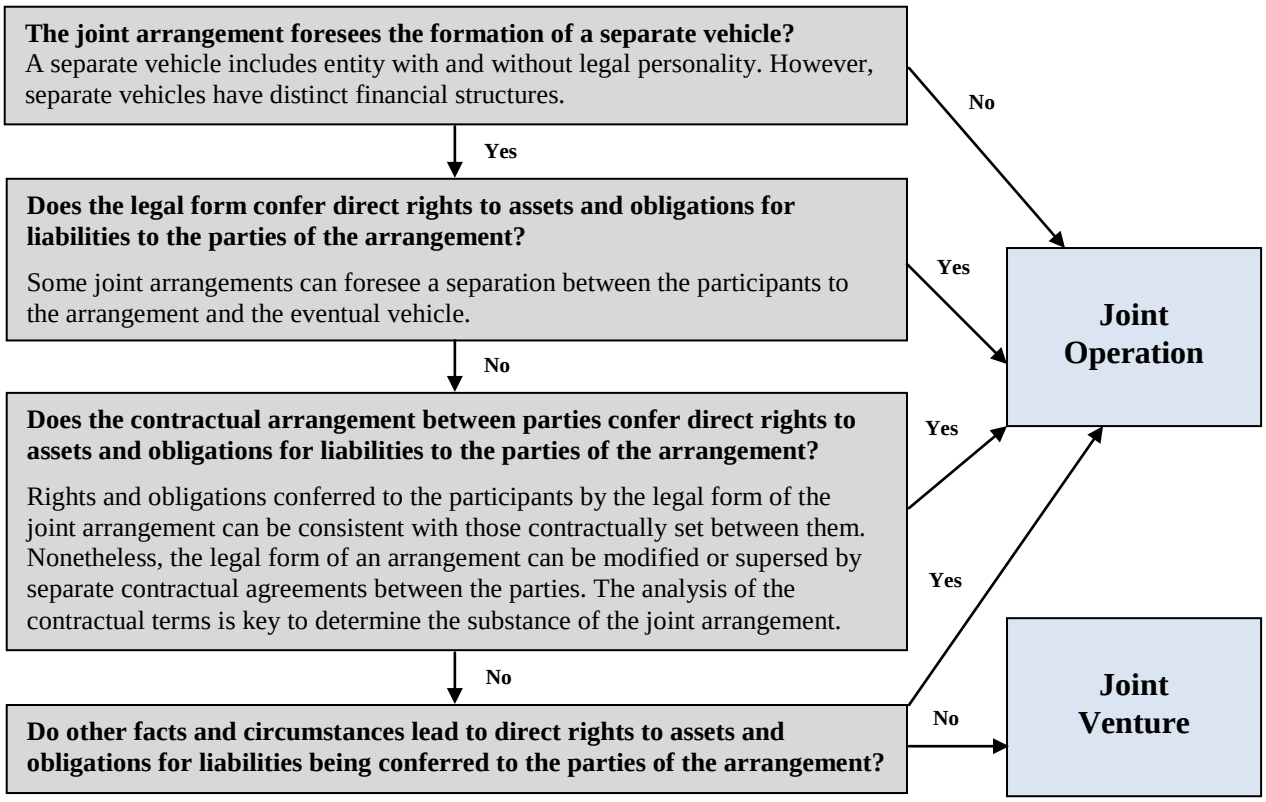
Source: our elaboration based on IASB, 2011

Joint operations are defined as joint arrangements whereby parties that have joint control of the arrangement have **rights to the assets and obligations for the liabilities**

relating to the arrangements[1] (IFRS 11.15). On the other hand, **Joint ventures** are joint arrangements whereby the parties that have joint control of the arrangements have **rights to the net assets of the arrangement**[2] (IFRS 11.16).

A key aspect of the assessment process of a joint arrangement is the determination of what type of arrangement the agreement represents or, in other words, if the arrangement can be configured as a joint operation or a joint venture. The result of this analysis will drive the accounting treatment. IFRS 11 clarifies that an entity shall determine the type of joint arrangement in which it is involved by considering its rights and obligations arising from the arrangement. In this regards, it should assess its rights and obligations by considering the structure and legal form of the arrangement, the terms agreed by the parties in the contractual arrangement and, when relevant, other facts and circumstances (IFRS 11.17).

Figure n. 4: Determining the type of joint arrangement



Source: our elaboration

As it has shown in the figure above, when determining a joint arrangement as either a joint operation or a joint venture, the first step consists in assessing whether there is a separate vehicle. If not, the joint arrangement is automatically a joint operation. However, if there is a separate vehicle, the following factors need to be considered:

- Legal form of the separate vehicle: once it is determined that a separate vehicle exists, the second consists in analysing the legal form of such separate vehicle. This is a significant change from IAS 31, under which the accounting only depended on whether an entity existed. Under IFRS 11, the legal form of the separate vehicle must be assessed to determine whether it gives the parties rights

[1] E.g. each party has contractually an interest in individual assets and obligations for specific liabilities of the arrangement.

2 E.g. the arrangement only gives rights to each party to a share of the net outcome generated by an economic activity.

to net assets, or rights to the assets and obligations for the liabilities of the arrangement. In other words, the matter is if the separate vehicle confers separation between the parties and the separate vehicle.

- Contractual terms and conditions: the next step in classifying a joint arrangement is to examine the contractual terms of the arrangement. This is because even if the legal form of the separate vehicle establishes rights for each of the parties, the contractual terms of the joint arrangement may unwind the effects of the legal form and give the parties rights to the assets, and obligations for the liabilities. It is worth noting that this requirement is further evidence that, when classifying a joint arrangement, IFRS 11 focuses on the nature and substance of the rights and obligations of the joint arrangement, as compared with IAS 31 which just looked to the form of the arrangement.
- Other facts and circumstances: if the preliminary assessment of the legal form and the contractual terms of the joint arrangement indicate that a joint arrangement may be a joint venture, then the parties must consider any other facts and circumstances to determine whether the parties have rights to the assets and obligations for the liabilities, which would make it a joint operation.

Joint arrangement accounting

Whit reference to the accounting treatment of a joint arrangement, IFRS 11 distinguishes between the accounting treatment of joint operations and, on the other hand, the accounting treatment of joint ventures.

Joint operations

A joint operator, which is a party that has joint control in a joint operation, will need to recognise, in its separate and consolidated financial statements, the following in relation to its involvement in the joint operation:

- Its assets, including its share of any assets held jointly;
- Its liabilities, including its share of any liabilities incurred jointly;
- Its revenue from the sale of its share of the output arising from the joint operation;
- Its share of revenue from the sale of the output by the joint operation; and
- Its expenses, including its share of any expenses incurred jointly (IFRS 11.20).

A joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRSs applicable to the particular assets, liabilities, revenues and expenses (IFRS 11.21).

That is, it is important to notice that there is sometimes confusion whether accounting for a joint operation is the same as proportionate consolidation (which an entity could use to account for jointly controlled entities in accordance with IAS 31. In this regard, for former jointly controlled entities that are classified as joint operations under IFRS 11, it may not be clear whether the adoption of IFRS 11 will affect the joint operator's financial statements.

When a joint operator has rights to a specified percentage of all assets and obligations for the
same percentage of all liabilities, there would probably not be a difference between the accounting for a joint operation and proportionate consolidation in practice. On the other side, when the joint operator has different right (and percentages) to various assets, and/or different obligations for various liabilities, the financial statements would look different when accounting for those individual rights and obligations, compared with proportionately

consolidating a blended percentage of all assets and liabilities. In fact, a joint operator may have rights and obligations with respect to the assets, liabilities, revenues and expenses relating to a joint operation that might differ from its ownership interest in the joint operation. In such a case, the joint operator has to recognize assets, liabilities, revenues and expenses according to its shares in the assets, liabilities, revenues and expenses of the joint operation as determined and specified in the contractual arrangement, rather than basing this recognition on the ownership interest that it has in the joint operation (see the example below).

Example: joint operation accounting

A and B establish a joint arrangement using a separate vehicle (C), but the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle itself. That is, A and B have rights to the assets and obligations for the liabilities of C (C is a joint operation). Neither the contractual terms, nor the other facts and circumstances indicate otherwise. Accordingly, A and B account for their rights to assets and their obligations for liabilities relating to C in accordance with the IFRS applicable to the particular assets, liabilities, revenues, expenses.

A and B each own 50% of the equity (e.g., shares) in C. However, the contractual terms of the joint arrangement state that A has the rights to all of Building No. 1 and the obligation to pay all
the third party debt in C. A and B have rights to all other assets in C, and it has obligations for all other liabilities in C in proportion to their equity interests (i.e., 50%).

C's balance sheet is as follow:

Assets		**Liabilities and equity**	
Cash	20	Debt	120
Building n.1	120	Employee benefit plan obligation	50
Building n.2	100	Equity	70
Total assets	**240**	**Total liabilities**	**240**

In order to account for its rights to the assets in C and its obligations for the liabilities in C, A would record the following in its financial statements:

Assets		**Liabilities and equity**	
Cash	10	Debt	120
Building n.1	120	Employee benefit plan obligation	25
Building n.2	50	Equity	35
Total assets	**180**	**Total liabilities**	**180**

This situation may differ from the amounts recorded using proportionate consolidation.

Joint ventures

One of the main reasons for issuing IFRS 11, as said before, was to eliminate proportionate consolidation as an option for accounting for jointly controlled entities to

converge with US GAAP. As a result, joint ventures (many of which will likely have been jointly controlled entities under IAS 31) will be accounted for using the equity method.

The venturer will measure, in its consolidated financial statements, its investment in the joint venture with the equity method in accordance with IAS 28 "Investments in Associates and Joint Ventures" unless the entity is exempted from applying the equity method as specified in that standard. (IFRS 11.24). The carrying amount of the investment is initially recognized at cost as one-line item and subsequently adjusted based on changes of the share of the investor in the equity of the investee. The adjustment to the carrying amount is posted, in the consolidated financial statements of the investor, against:

- The income statement, in the measure of its share of the net result of the investee of the period;
- OCI, in the measure of its share of the change in OCI of the investee in the period.

Moreover, the carrying amount of the investment is decreased for any dividends received from the joint venture (Baril and Betancourt, 2013).

That is, if an arrangement is classified as joint venture under IFRS 11, this standard will entail, in the consolidated financial statements, abandoning the proportionate consolidation method and adopting the equity method, retroactively, at the beginning of the immediately preceding period (so called 'transition date')[3]. In these cases, the venturer's share of the carrying amount of the net assets, at the transition date, will be reported in one line item, denominated 'Investments in joint ventures', which includes any goodwill (currently recognized separately with the proportionate consolidation method). The amount so determined is the 'opening balance' and represents the deemed cost of the investment, which will be subject to impairment test at the transition date (any impairment will be recognized to equity, through retained earnings).

Regarding the accounting in the separate financial statements, the venturer will recognize an investment in the joint venture at cost, or in accordance with IAS 39.

Business impact

IFRS 11 mainly represents a change in the accounting for those arrangements that were classified in IAS 31 as 'jointly controlled entities'. In this regard, the change will mainly depends upon the accounting method used by entities when accounting for their 'jointly controlled entities' in accordance with IAS 31 and on the classification of those arrangements in accordance with IFRS 11 (ie 'joint operations' or 'joint ventures').

In particular, the most significant change, which might potentially affect a larger number of arrangements, consists of those 'jointly controlled entities' that were proportionately consolidated in IAS 31 that will now be 'joint ventures' and, in accordance with IFRS 11, will be accounted for using the equity method. The requirements of IFRS 11 might, to a lesser extent, also lead to accounting changes for 'jointly controlled entities' that were accounted for using the equity method in accordance with IAS 31 and will be 'joint operations' in accordance with IFRS 11 (IASB,2011).

In this context of change, management should evaluate the new requirements of IFRS 11 and the impact that the change in accounting may have upon its financial statements. This change may have a significant impact on the key performance indicators (revenues, EBIT, EBITDA, leverage ratios) used to assess the entity's performance. For example, entities that change from proportionate consolidation to the equity method will generally report lower amounts for assets and liabilities (although the net investment in joint ventures remains unaffected) and lower revenues and expenses (although net income remains unaffected),

[3] For example: effective date = 1 January 2013, transition date: 1 January 2012.

(IASB, 2011). In view of these considerations, it will become really important a clear communication with stakeholders when significant changes in the presentation of financial results and financial position are expected to occur.

Moreover, it is important to notice that entities may need more detailed financial reporting information from an operator of a joint operation to comply with the new accounting and disclosure requirements. Therefore, changes in existing process and controls may be required to cope with initial transition requirements and the annual reassessment of arrangements. Gathering and analysing the information could take considerable time and effort depending on the number of joint arrangements, the inception dates and the records available (PwC, 2011).

Conclusions

In May 2011 IASB introduced a new standard, IFRS 11 – Joint Arrangements. This standard is effective, within the EU, for annual periods beginning on or after 1 January 2014 and replaces the guidance previously provided by IAS 31 and SIC-13.

IFRS 11 redefines the framework for the accounting for joint arrangements. By so doing, the introduction of this new standard could affect a reporting entity's financial statement, and management should doubtless consider the impact of IFRS 11 on entity's key financial and economical results.

Since IFRS 11 has not been applied yet (it's effective for years beginning on or after 1 January 2014), no empirical researches are possible. In fact, the final reports of the entities applying IFRS 11, at this stage, are not available, so we cannot be certain about the effects of adopting the standard. This aspect is the main limitation of our study which is focused, in this stage, just on the theoretical aspects issued in the new standard (and on its potential business impact). Therefore, with reference to the future developments of the study, for the next future we intend to carry out this research through empirical studies aimed at providing some evidence about the effects of the application of IFRS 11.

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