Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In depth“ zur Thematik „Measurement of joint operations: Reading between the lines” stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In depth on IFRS 11
Measurement of joint operations: Reading between the lines

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Contents

At a glance

Measurement of a joint operation (JO) is largely unaddressed in IFRS 11, 'Joint Arrangements', and as such, some diversity in practice has developed. This guide walks through some common JO measurement issues, discussing the measurement approach(es) observed under today's guidance.

It also covers the recent amendment to IFRS 11 which requires the application of IFRS 3 to transactions where an investor obtains an interest in a JO that constitutes a business. The new guidance is mandatory from January 2016, prior to which a policy choice is available and must be applied consistently for each arrangement.

The source of the confusion

The guidance in IFRS 11 primarily focuses on the classification of joint arrangements, providing definitions for joint control and types of arrangements. It also offers several pages of application guidance and multiple illustrative examples to assist with the classification assessment.

The guidance places less emphasis on recognition and measurement of joint arrangements. Joint ventures are accounted for using the equity method under IAS 28, 'Investments in associates and joint ventures', eliminating the need for additional recognition and measurement guidance in IFRS 11 (IFRS 11 para 24).

JOs do not have a similar direct linkage to another standard. Instead, IFRS 11 offers a broad principle – Investors should recognise their share of assets, liabilities, revenues and expenses in accordance with applicable IFRSs (IFRS 11 paras 20–21). Application of this principle raises several important questions, including:

- How is an investor's 'share' determined?
- Which IFRS applies?
- Is there only one 'correct' way to account for each JO?

IFRS 11 does not provide any additional application guidance or detailed examples that speak to these issues. In fact, the only specific measurement guidance for JOs relates to the gain/loss recognition of an investor in upstream and downstream transactions (IFRS 11 para B34). Even that guidance leaves room for interpretation.

Over the next few pages, we 'read between the lines' of IFRS 11, providing insight to JO measurement and analysing what we have observed in practice.

This publication is designed to provide insight to measurement of joint operations. Each arrangement presents a unique set of facts and circumstances that must be evaluated individually. Nothing in this guide should be read as overriding the accounting standards or regulatory requirements.

Taking your fair share

The first step in JO measurement is to determine what should be measured.

No legal separation

Determination of 'what to measure' is typically straightforward for JOs that are not contained in a separate vehicle or for those contained in a structure that does not create legal separation:

- Investors maintain rights to their own assets and incur their own liabilities.
- Revenue and expenses are either directly attributable to an investor or shared based on the level of investment.

The terms that establish the JO (for example, a contract or general partnership agreement) often specify the points above or default to legal attribution. Recognition follows this path, and an investor would use the applicable IFRS for each item recognised (such as IAS 16 for property, plant and equipment; IAS 18 for revenue; or IFRS 3 for a business combination).

Observation from practice

'What to measure' becomes more challenging as the arrangement increases in complexity. However, we observe that complicated sets of contracts or vague contractual terms tend to raise more fundamental issues in an arrangement. They call into question, for example, whether joint control has truly been established, which assets are legally part of the arrangement, and which investor has legal responsibility for particular liabilities. These issues must be resolved before one can accurately determine what should be measured (and, potentially, how it should be measured).

Vehicle with legal separation

The same determination is more complicated where the JO is contained in a vehicle that creates legal separation; that is, a separately identifiable financial structure that, by its legal form, creates legal separation between the investors and the assets/liabilities of the joint arrangement.

Both limited liability companies (LLCs) and limited partnerships (LPs) can create this type of legal separation. We will use an LLC to represent this type of legal form for brevity throughout the remainder of this guide. However, any legal form that creates a similar level of separation between an investor and the arrangement in the applicable jurisdiction should be considered.

JO classification for an arrangement structured as an LLC would imply that the legal form was overcome either by contractual terms between the investors or an assessment of 'other facts and circumstances'. In either case, determination of 'what to measure' can be complicated.

Successful use of contractual agreements to supersede the rights created by the legal form of an LLC is a high hurdle. We would expect contracts in these cases to contain sufficient detail to specify which investor has direct rights to a particular asset and/or obligation for a particular liability. However, investors might lack clarity on 'their share' for any item that is not specified by the contracts.

JO classification due to 'other facts and circumstances' can create additional confusion. For example, consider an arrangement where the investors have a binding obligation to take substantially all of the output in a proportion different from their ownership interest.

Significant judgement might be needed to provide a faithful representation of the arrangement and the underlying economics. In practice, companies might define 'share' based on all of the following (to the extent that they are not specified in a contract or legal arrangement):

- Amount of output taken (typically as a percentage).
- Ownership percentage.
- Voting percentage (if different from ownership).
- Distribution of revenue or profits (if contractually defined differently from the other percentages above).

Some situations might even be represented best by a combination of the items above due to contractual terms – For example, revenue/expenses split based on contractual agreement, and share of assets and liabilities default to ownership percentage.

A final layer of complexity might exist if the investors in a single arrangement reach different classification decisions due to asymmetrical rights or exposure. For example, consider a typical LP structure between two investors and assume that there is joint control – one investor is the general partner and the other is a limited partner. IFRS 11 has a focus on rights and obligations which could result in a general partner classifying the arrangement as a JO, while the limited partner might classify it as a JV due to narrower exposure. This type of classification disconnect is rare and should be evident from the contractual terms. However, measurement by the two investors will not be comparable when it occurs.

Observation from practice

Judgement should be applied consistently to all similar transactions. Similar outcomes should be reached for similar fact patterns.

Illustrative example – Investors obligated to take all of the output

Facts:

SlowGo and StopCo are two auto suppliers that specialise in braking components for motor vehicles (such as rotors and pads). They each contribute cash to a new, jointly controlled LLC that makes custom brake pads. The arrangement enables them to combine technologies and achieve economies of scale that they would not have achieved separately.

The arrangement is classified as a JO, because the shareholder agreement requires the investors to take 100% of the output at an estimated market price. Specifically, it requires SlowGo to take 60% and StopCo to take 40% of the annual production. Profits are split based on ownership level (50/50).

Question:

What is SlowGo's share of the JO?

Solution:

It depends. More information is needed to determine whether the share of output or the ownership level is a significantly better representation of the transaction. You need to consider why the disconnect between ownership interest and output level exists. For example:

1. Why are the investors required to take all of the output?
2. Did one investor contribute more initial capital or assets than the other?
3. Does the split of output taken change over time?

Additional facts:

SlowGo and StopCo agreed to take all of the output because they each have robust distribution networks that can be leveraged effectively without creating a new process in the LLC. They each contributed the same level of initial capital. They agree to take disproportionate shares of output based on their current distribution networks; however, the split of output can be adjusted each year. All purchases are made at an estimated market price, creating market-based returns for the LLC.

Solution:

All facts seem to indicate that each party has a 50/50 share of the arrangement (ownership and economics appear to be shared evenly).

Obtaining an interest

The key challenge in accounting for the acquisition of an interest in a JO is the nature of the transaction. An investor will make one payment or one contribution to obtain its share in the JO (such as a cash payment for a percentage interest in the assets, liabilities, revenue and expenses). Examples of common transactions include:

- Cash payment for an interest in a contractual arrangement or to obtain shares in an entity (that is, capital contribution or share purchase).
- Asset contribution (by contract or as capital contribution).
- Purchase of an undivided interest in a jointly controlled business.

The accounting alternatives for these transactions are actually quite limited by the guidance, despite the numerous variations that exist: where consideration is paid for a group of assets and liabilities, the guiding principles are based on either an asset acquisition or a business combination.

The nature of the JO and the nature of the interest affect which approach(es) might be applicable (as discussed in the next section). For example, whether the JO constitutes a business under IFRS 3 (nature of the JO) indicates the applicability of the business combination principles (that is, IFRS 3 cannot be applied to an arrangement that is not a business). In a similar way, an undivided interest in an exploration asset (nature of the interest) requires asset acquisition accounting, even if the assets are expected to be developed into a business in the future.

We take a closer look at some of the key considerations in the following sections, but we start by summarising two common accounting approaches in the following table:

	Asset acquisition	Business combination
Assets and liabilities	Consideration paid is allocated to assets acquired, and the investor recognises its share of liabilities assumed	Fair value of assets and liabilities acquired (based on investor's share)
Deferred tax	IAS 12 initial recognition exemption is available (usually no deferred tax is recognised)	Recognised in accordance with IFRS 3 (can result in substantial amount of deferred tax)
Goodwill	Not recognised	Recognised in accordance with IFRS 3
Contingent liabilities	Not recognised, although it might impact transaction price and asset valuation	Recognised in accordance with IFRS 3
Transaction costs	Form part of the cost of the asset	Expensed in the period
Other		All other principles in IFRS 3 are applied, unless considered contradictory to IFRS 11

A business or not a business …? That is the question

The nature of the JO tends to be the primary driver for an investor's accounting when acquiring an interest.

Not a business

The accounting for the acquisition of an interest in a JO that does not constitute a business is clear – The transaction is an asset acquisition. No business exists, so the principles of business combination accounting are not applicable. Consistency is easily achieved, because the same accounting applies to all transactions that meet this description, regardless of the form of consideration (such as cash or assets) and/or type of transaction (for example, initial interest at formation of the JO, obtaining an additional interest or buying-in as a third party).

Illustrative example – Not a business

Facts:

Two investors (CrudeCo and PetroliCo) establish a joint arrangement in a general partnership for the exploration and eventual production of oil. The partnership is in the early exploration phase and, as such, holds a single asset – The exploration licence. In addition, CrudeCo notes the following:

a. The licence obtained by the partnership has a fair value of C150.

b. rudeCo contributed cash of C90 for its share in the partnership, and incurred transaction costs of C10.

Assume that CrudeCo has analysed the arrangement and determined the following:

(i) Joint control is clearly established and JO classification is appropriate.

(ii) The partnership does not constitute a business under IFRS 3.

Question:

How does CrudeCo account for obtaining its interest in the partnership?

Solution:

CrudeCo would record its 50% interest in the licence as an intangible asset at the cost paid (C100 = contribution + transaction costs). No deferred tax or goodwill would be recognised.

Business

The accounting for the acquisition of an interest in a JO that constitutes a business is not as obvious. On one hand, the transaction does not result in one party obtaining control of a business, so it does not meet the definition of a business combination. On the other hand, all other acquisitions of a significant stakeholding in a business require the application of business combination principles in some form (for example, a notional purchase price allocation is performed when an equity method investment is made); thus, applying the asset acquisition method seems to be a step away from the existing guidance for similar transactions.

The current guidance in IFRS 11 does not provide additional clarity or interpretation to the points above. Diversity in practice has developed.

Observation from practice

Accounting for these transactions varies from a strict application of the asset acquisition method to a wide range of applications of the business combination principles. However, application of all IFRS 3 requirements is rarely observed.

Several industries have created a hybrid application that minimises goodwill but does include the recognition of some deferred taxes (although typically not as much as would be seen in full IFRS 3 accounting). Transaction costs are included in the consideration paid, and contingent liabilities might or might not be recognised.

The lack of current guidance means that a policy choice is available; it is acceptable under current guidance to apply the asset acquisition method or IFRS 3 requirements, until the amendment is effective from January 2016.

Additional interest

The assessment of whether a specific JO constitutes a business should be made each time an investor obtains an interest. The same accounting approach should be applied for all transactions with a single JO, assuming that the nature of the JO is the same.

A previously held interest in a JO should not be remeasured when an additional interest is obtained (assuming that joint control is maintained), regardless of whether the JO constitutes a business.

Observation from practice

We have not observed remeasurement of a prior interest in a JO in practice.

The requirement to remeasure a previously held equity interest in a business is only applicable to a transaction when an investor obtains control of the business. IFRS guidance does not permit a similar remeasurement when the level of control (that is, control, joint control or significant influence) remains the same before and after the transaction.

For example, IAS 28 does not permit remeasurement when an investor increases its holding from 30% to 40% but maintains significant influence in an associate. Similarly, a controlling party does not remeasure its interest when increasing its investment in a subsidiary, assuming that control is maintained.

As such, a joint operator's purchase of an additional interest in a JO, without obtaining control, would not be viewed as a significant economic event that warrants remeasurement of the previously held interest.

Amendment to IFRS 11 (effective January 2016)

The new guidance requires **all** business combination principles in IFRS 3 to be applied, unless a specific item is considered contradictory to the guidance in IFRS 11. It applies to the acquisition of an initial interest in a JO as well as the acquisition of an additional interest in a JO. The amendment also prohibits the remeasurement of a prior interest in a JO when an additional interest is obtained and joint control is maintained.

The IASB issued the amendment to IFRS 11 in May 2014 to address the diversity in practice related to the accounting for the acquisition of an interest in a JO where the JO constitutes a business (as defined in IFRS 3). The IASB acknowledged that, even though the JO constitutes a business, the acquisition of an interest in a JO does not meet the definition of a business combination (that is, control is not obtained by a single party). However, the IASB expects that the IFRS 3 approach will result in more consistent application and aligns with current guidance for similar transactions (such as the notional PPA performed for an equity method investment in a business).

The amendment is effective for transactions that occur in annual periods beginning in January 2016. It will be applied prospectively and can be early adopted. The amendment has not been endorsed by the EU as of the date of this publication

Observations on new guidance

We expect few companies to early adopt, because the amendment is likely to increase both the effort and the cost of accounting for these transactions. It will also increase the amount of deferred tax and goodwill recognised.

The new guidance will place additional pressure on the definition of a business – a topic widely debated in industries where some of these JOs are most common (such as oil and gas, mining and real estate).

Bonus section – What to do when you obtain control

'Control' and 'joint control' are mutually exclusive concepts. Thus, a transaction by which an investor obtains control of a JO ends the joint arrangement. As such, the transaction is not in the scope of IFRS 11. However, these transactions occur in practice, and the accounting has direct linkage to several topics already discussed above.

Note: the commentary below assumes that the investor obtaining control of the JO was a joint operator immediately prior to the transaction.

Not a business

The asset acquisition method continues to be used where the investor obtains control of a JO that does not constitute a business. The consideration paid, along with any direct transaction costs incurred, are recognised on the balance sheet as the cost accumulation of the related asset(s).

Business

A business combination is defined as an investor obtaining control of a business, including a business contained in a JO prior to the transaction. Thus, all principles in IFRS 3 apply to the transaction.

Observation from practice

Application of IFRS 3 varies for transactions where an investor obtains control of a JO that constitutes a business.

Legal entity

We observe consistent application where the business is contained in a legal entity. All assets and liabilities are measured at fair value. Deferred taxes, goodwill, contingent liabilities, contingent consideration and noncontrolling interest are all recognised to the extent applicable. Previously held equity interests are remeasured, and any resulting gain/loss is taken to income. In summary, all requirements of IFRS 3 are applied.

No legal entity

We observe greater variation where the business is not contained in a legal entity (typically a JO that had been created by contract), because the application of some principles in IFRS 3 becomes problematic. For example, another investor's retained ownership in the business might not meet the definition of noncontrolling interest (for example, the other investor does not have an equity interest, but does maintain an ownership interest). As a result, diversity in practice exists, with the accounting for many of these transactions using some variation of the following approach:

(a) Assets/liabilities recognised at fair value only to the extent of the controlling party's share.
(b) Deferred tax and goodwill recognised relative to the amount of assets and liabilities recognised.
(c) NCI not recognised.
(d) Previously held interest is not remeasured assuming it is not considered an equity interest (that is, it does not meet the requirements of IFRS 3 para 42).[1]

[1] As of the date of this publication, the Interpretations Committee was considering this issue for further guidance: the remeasurement of a previously held interest where control is obtained over a JO that is not contained in a legal entity.

Appendix – Illustrative examples

The following examples provide illustrations of some common transactions to obtain an interest in a JO; each example includes sample journal entries of the approaches observed in practice.

Assume the following base facts for all illustrative examples:

- Joint control exists and JO classification is appropriate.
- The JO constitutes a business under IFRS 3.
- A partnership does not create legal separation between investors and the arrangement.
- No prior interest is held in the JO.

Illustrative example 1 – Cash payment

Facts

Entity A pays C200 for a 50% share in a partnership at its formation. Transaction costs of C8 are incurred. The fair value of the identifiable assets and liabilities of the partnership business is C360.

Solution

Entity A can apply the asset acquisition method or the business combination principles prior to the effective date of the IFRS 11 amendment. Sample journal entries for both approaches are provided.

Dr	JO assets (net of liabilities)	208	
Cr	Cash		208

*Business combination**

Dr	FV of net assets x 50% (assume def tax included)	180	
Dr	Goodwill	20	
Dr	Expense – transaction costs	8	
Cr	Cash		208

** Note: IFRS 11 prohibits the use of proportionate consolidation. However, in some circumstances, the application of the IFRS 11 measurement principles for JOs might have a similar result as proportionate consolidation under the prior model for initial recognition. The application of the relevant IFRS for each asset/liability means that this consistency is less likely to be maintained in subsequent periods.*

Illustrative example 2 – Contribution of assets

Facts

Same fact pattern as example 1, except that entity A contributes PPE instead of cash. The fair value of the contributed assets is C220, and entity A's carrying value was C200.

Solution

The recognition of the interest in the JO is similar to example 1. However, an additional factor must be considered – the amount of gain recognised on the contribution of the assets.

The gain is limited to the interest of the other investors (application of IFRS 11 para B34). Sample journal entries for both approaches are provided.

Asset acquisition

Dr	JO assets (net of liabilities)	218	
Cr	Cash (transaction costs)		8
Cr	PPE		200
Cr	Gain (50% of FV – CV)		10

*Business combination**

Dr	FV of net assets x 50% (assume def tax included)	180	
Dr	Goodwill	30	
Dr	Expense – transaction costs	8	
Cr	Cash		8
Cr	PPE		200
Cr	Gain (50% of FV – CV)		10

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