

## IFRS industry insights

### Joint arrangements in the life sciences industry



IFRS 11 does not change the definition of a 'joint arrangement' under IAS 31 as being "an arrangement of which two or more parties have joint control".

This industry insight publication highlights some of the key issues the life sciences industry is likely to encounter in adopting IFRS 11 *Joint Arrangements* and provides insight and examples to assist in the implementation of the standard. It also includes a comparison to accounting principles generally accepted in the United States of America (US GAAP).

IFRS 11, which replaces IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly-controlled Entities – Non-monetary Contributions by Venturers*, and is effective for annual periods beginning on or after 1 January 2013<sup>1</sup>, may have a significant effect on the accounting for joint arrangements in the life sciences industry. Joint arrangements are commonplace in the life sciences industry for various reasons, for example, as a means of increasing product pipelines and gaining access to new markets and technologies. Such arrangements can take many forms including collaborations, alliances, or joint arrangements. Identifying the structure of the arrangement is key to understanding the relevant accounting requirements.

IFRS 11 may impact the financial results and operational requirements for joint arrangements. Some of these potential impacts include:

| Key considerations  | Ratio              | Impact of a change from proportionate consolidation to the equity method   |
|---|--------------------|--|
| <b>Change in judgement:</b> IFRS 11 focuses on rights and obligations as opposed to the structure of the arrangement.   | Return on capital  | The accounting change is not expected to impact the metric.  |
| <b>Accounting policies:</b> Entities that account for jointly controlled entities using proportionate consolidation under IAS 31 will need to change their accounting policies. Management should consider the legal form, the terms of contractual arrangements, and other facts and circumstances, in assessing classification under IFRS 11. | Profitability      | The accounting change may cause the metric to increase or decrease depending on the results of the joint venture (relative to the group).  |
| <b>Financial metrics:</b> The elimination of the option to proportionately consolidate under IFRS will impact financial data/ratios. Entities not currently applying proportionate consolidation under IAS 31 may also be affected by the application of IFRS 11.   | Asset turnover     | The accounting change will cause reported revenue and total assets to decline. The final effect on the ratio will depend on the absolute and relative changes of revenue and assets. |
|   | Financial leverage | The accounting change may cause the metric to increase or decrease depending on the results of the joint venture (relative to the group).  |

#### What is a joint arrangement?

IFRS 11 does not change the definition of a 'joint arrangement' under IAS 31 as being "an arrangement of which two or more parties have joint control". Joint control exists when the unanimous consent of those parties sharing control is required to make decisions about the relevant activities, and relevant activities are considered those activities that significantly affect the returns on the arrangement. *Control*, as applied in the definition of joint control, is consistent with the definition in IFRS 10 *Consolidated Financial Statements* – a standard which was issued concurrent with and became effective at the same point in time as IFRS 11.

<sup>1</sup> The endorsed effective date for IFRS 11 in Europe is 1 January 2014. However, early application is permitted.

## IFRS 11 classifies joint arrangements into two types – joint operations and joint ventures – each having its own accounting model.

### Example

IFRS 11 provides guidance for determining whether joint control exists assuming all the parties, or a group of parties, are found to control the arrangement as defined in IFRS 10.

In a joint arrangement, a party with joint control can prevent any of the other parties from making unilateral decisions without its consent. For example, assume establishment of an arrangement to research and develop (R&D), manufacture, and distribute a pharmaceutical product.

If two parties to the arrangement, Pharma A (A) and Pharma B (B), each have 50 per cent of the voting rights throughout each phase of the arrangement and the contractual arrangement between them specifies that at least 51 per cent of the voting rights are required to make decisions about the relevant activities, the parties have implicitly agreed that they have joint control of the arrangement because decisions about the relevant activities cannot be made without both parties agreeing.

However, as illustrated in the following example, not all parties to the arrangement need to share control over the arrangement for it to be considered a joint arrangement.

Assume the above arrangement is modified such that the arrangement has three parties – A and B, as well as Pharma C (C). A has 50 per cent of the voting rights in the arrangement and B and C each have 25 per cent. The contractual arrangement between A, B, and C specifies that at least 75 per cent of the voting rights are required to make decisions about the relevant activities of the arrangement. Even though A can block any decision, it does not control the arrangement because it needs the agreement of either B or C. In this example, A, B, and C collectively control the arrangement. However, there is more than one combination of parties that can agree to reach 75 per cent of the voting rights (i.e., either A and B or A and C). In such a situation, to be a joint arrangement, the contractual arrangement between the parties would need to specify which combination of the parties is required to agree unanimously to decisions about the relevant activities of the arrangement.

As illustrated in the following example, sometimes an arrangement is structured so that all parties have a vote but a single party can direct the relevant activities unilaterally.

Assume the above arrangement is modified such that A, B, and C have 60 per cent, 30 per cent, and 10 per cent of the voting rights in the arrangement, respectively. The voting rights remain the same throughout each phase of the life sciences arrangement and all relevant decisions require a majority vote. Since A can unilaterally make decisions without the support of B and/or C, this arrangement does not represent a joint arrangement and IFRS 11 would not be applicable.

To evaluate whether A has control, it would be necessary to assess whether A has exposure to variable returns, and the ability to affect those returns through its power, as required by IFRS 10.

### How should joint arrangements be classified?

IFRS 11 classifies joint arrangements into two types – joint operations and joint ventures – each having its own accounting model. The key distinguishing factor between the two types of arrangements is based on the nature of the rights and obligations of the parties to the arrangement. In a joint operation, the parties to the joint arrangement (referred to as 'joint operators') have rights to the assets and obligations for the liabilities of the arrangement. By contrast, in a joint venture, the parties to the arrangement (referred to as 'joint venturers') have rights to the net assets of the arrangement.

Under IFRS 11, when there is no separate vehicle in place, the joint arrangement would be classified as a joint operation because without the existence of such a vehicle, the parties have rights to the individual assets and obligations for the individual liabilities of the arrangement. A *separate vehicle* is a separately identifiable financial structure, including legal entities or entities recognised by statute, regardless of whether those arrangements have a legal personality. This analysis is generally consistent with the application of IAS 31.

## Contractual arrangements between the parties to the joint arrangement may reverse or modify the rights and obligations conferred by the legal form of the vehicle.

However, in a change from IAS 31, a legal entity or structure-based distinction does not direct classification in and of itself. IFRS 11 carves out from the structure-based population those arrangements in which the separation is overcome by the legal form, contractual terms, or other facts and circumstances. In many cases, the legal form of the separate vehicle will be such that the separate vehicle must be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are those of the separate vehicle and not those of the parties to the arrangement), providing an initial indication that the joint arrangement is a joint venture. In some situations the existence of a legal entity will not directly affect the rights and obligations of the parties to the assets and liabilities. An analysis of all relevant facts and circumstances will usually be required in determining whether the vehicle should be considered in its own right and therefore considered a joint venture or a joint operation.

IFRS 11 provides the following guidance on factors to consider in the classification of a joint arrangement:

### Legal form of the separate vehicle

A joint arrangement that is conducted through a separate vehicle may offer the investors no separation between the parties to that arrangement and the separate vehicle. This indicates that the joint arrangement is a joint operation. However, a joint arrangement that confers separation between the parties and the separate vehicle would not necessarily indicate that the arrangement is a joint venture because the terms of the contractual arrangement or other facts and circumstances may affect whether the parties have rights to the assets and obligations for the liabilities of the joint arrangement.

### Terms of the contractual arrangement

Contractual arrangements between the parties to the joint arrangement may reverse or modify the rights and obligations conferred by the legal form of the vehicle. For example, parties may have direct rights to the assets and obligations for the liabilities of the arrangement despite the fact that the legal form of the vehicle would normally indicate that the parties have rights to the net assets and shelter the investors from having a direct obligation for the liabilities of the arrangement. This would be the case if the contractual arrangement between the parties establishes that all parties to the arrangement are directly liable for third party claims, or establishes a sharing of revenues and expenses based on the relative performance of the parties.

### Observation

When a joint arrangement is structured through a separate vehicle, it is necessary to carefully review the terms of the contractual arrangement in order to establish whether the parties to the arrangement have both rights to the assets and obligations for the liabilities and, in doing so, determine whether the arrangement constitutes a joint operation. It will be necessary to assess whether any contractual terms relating to the parties sharing the assets and liabilities of the arrangement are substantive, and whether those terms are sufficient to modify or reverse the separation of the parties from the rights and obligations of the joint arrangement that is conferred by the legal form of the vehicle.

For example, subject to considerations of the legal form of the vehicle and other facts and circumstances as required by IFRS 11:

- a contractual arrangement that modifies or reverses the rights and obligations conferred by the legal form of the vehicle so as to clearly establish that the parties to the joint arrangement share all interests in the assets, obligations, costs, and expenses relating to the arrangement in a specified proportion would lead to classification as a joint operation; and
- a contractual arrangement that establishes that the parties to the joint arrangement share all interests in the assets relating to the arrangement in a specified proportion *but* establishes that the separate vehicle is liable for the debts and obligations of the arrangement would lead to classification as a joint venture.

Examples of terms of the contractual arrangement which should be considered in classifying joint arrangements include, but are not limited to:

| Indicators of a joint operation   | Indicators of a joint venture   |
|---|---|
| The parties share all interests in the assets, liabilities, revenues, and expenses in a specified proportion. | The parties have no interests in individual assets and are liable for all liabilities of the arrangement.           |
| The parties are jointly and severally liable for the obligations of the arrangement.                          | The parties are liable under the arrangement only to the extent of their respective investments in the arrangement. |

IFRS 11 does not provide any additional guidance on what is meant by 'substantially all' in the context of evaluating whether parties to an arrangement have rights to substantially all of the economic benefits.

#### Other facts and circumstances

When a separate vehicle is used that confers separation between the parties and the vehicle and the terms of the contractual arrangement do not indicate that the joint arrangement is a joint operation, the parties should consider any other relevant facts and circumstances in determining the type of arrangement. For example, if a separate vehicle is formed to hold the assets and liabilities of the joint arrangement, the parties involved have rights to 'substantially all' of the economic benefits of the arrangement's assets (e.g., parties have committed to purchase all of the arrangement's output), and the parties are substantially the only source of cash flows contributing to the arrangement's operations, this generally indicates that the arrangement is a joint operation. However, if the joint arrangement was able to generate operational cash flows from third parties, this would indicate the joint arrangement is a joint venture because the joint arrangement would assume demand, inventory, and credit risks.

#### Observation

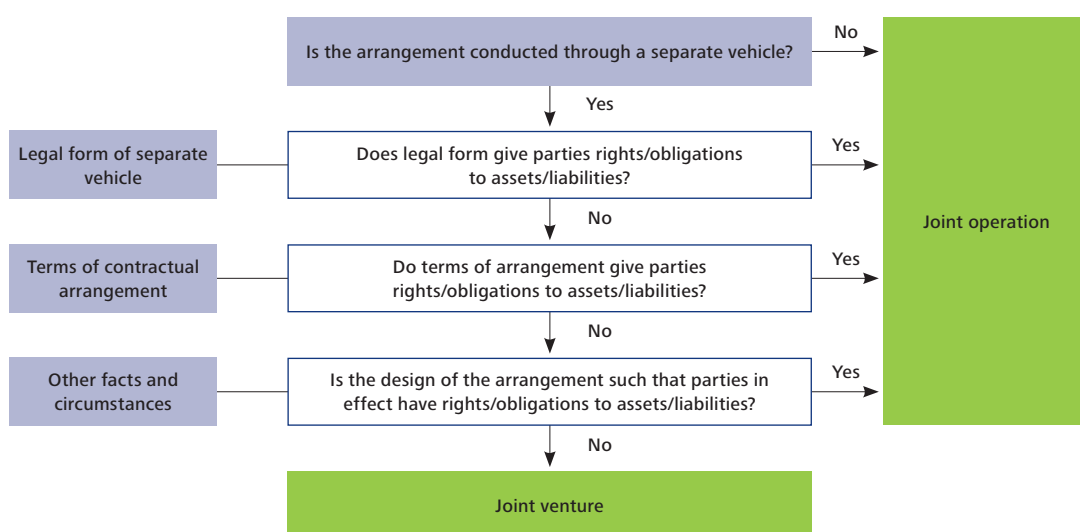
IFRS 11 does not provide any additional guidance on what is meant by 'substantially all' in the context of evaluating whether parties to an arrangement have rights to substantially all of the economic benefits of the arrangement's assets. However, if the arrangement is such that the parties to the joint arrangement take 90 per cent or more of the output of the joint arrangement, this should generally be presumed to be sufficient to conclude that they have rights to substantially all the economic benefits of its assets.

For a joint arrangement to be classified as a joint operation, IFRS 11 also requires that the parties to the joint arrangement have obligations for its liabilities. This can arise from an obligation to purchase output (but not merely a right, intention, and/or expectation to do so) that results in the parties being substantially the only source of cash flows contributing to the continuity of the operations of the arrangement. As with the assessment of rights to economic benefits, 'substantially' in this context should generally be presumed to mean 90 per cent or more of those cash flows.

The assessment of whether the parties to the joint arrangement have rights to 'substantially all' its assets and are 'substantially' the only source of cash flows contributing to its operations should be made at inception of the joint arrangement and should only be reassessed if there is a change in the parties' rights to the assets or obligation for the liabilities. The assessment should take into account the expected output and costs of the joint arrangement over its life (rather than only in the current or subsequent reporting period). Further, it should consider the purpose and design of the arrangement.

As illustrated below, all relevant factors must be considered in order to determine that a joint arrangement meets the definition of a joint venture.

Figure 1. Classifying a joint arrangement



It is important to note that the parties cannot base their evaluation solely on the legal form of the separate vehicle.

The following examples illustrate the analysis of classifying a joint arrangement:

#### Example

Company A (A) has a promising drug candidate that recently completed phase I of clinical development and seeks a collaboration partner to share the risk of further research and development (R&D) and the potential rewards of successful commercialisation. Therefore, A enters into a collaboration with Company B (B) to perform the phase II and potentially phase III clinical development, as well as to manufacture and distribute the pharmaceutical product upon receiving regulatory approval. A agrees to bear 60 per cent of the aggregate R&D expense for phases II and III, with B bearing 40 per cent. Each party to the transaction has certain responsibilities for R&D and for the potential manufacture and distribution of the commercialised pharmaceutical product and will record their respective expenses (and revenues upon commercialisation) on their own books (i.e., the joint arrangement is not structured through a separate vehicle). At each period end during the Phase II and III R&D, the parties will share their R&D expense information and will split the costs equally in accordance with their agreed upon contractual percentage. Following commercialisation, at each period end the parties will share their net sales information and will split the revenue equally in accordance with their agreed upon contractual percentage. All decisions require the unanimous consent of each party. Each party will use its own resources (e.g., assets, personnel) and incur its own liabilities in performing its required R&D activities. There are no separate assets or liabilities for the collaboration.

Assuming joint control exists, given there is no separate vehicle in place, the joint arrangement would be classified as a joint operation because without the existence of such a vehicle, the parties have rights to the individual assets and obligations for the individual liabilities of the arrangement.

However, if the arrangement is structured through a separate vehicle, a different conclusion may result. Assume each party (A and B) funds money into a separate vehicle established by the two parties solely for the purpose of performing the phase II and III R&D. The activities related to the arrangement take place within the separate vehicle rather than within the separate financial statements of A or B.

The parties could reach different accounting conclusions depending on the nature of the separate vehicle. If the separate vehicle is an unincorporated legal entity such as a partnership, the parties generally apply joint operation accounting (because partnerships that have unlimited liability often do not confer separation between the parties and the separate vehicle; instead, they provide the partners with rights to the assets and obligations for the liabilities – which are indicators the arrangement is a joint operation). However, if the separate vehicle is a corporation, the parties may not apply joint operation accounting (because, in many jurisdictions, a corporation confers separation between the parties and the separate vehicle and also provides the parties with rights to net assets – which are indicators the arrangement is a joint venture). It is important to note that the parties cannot base their evaluation solely on the legal form of the separate vehicle. The legal form of the separate vehicle assists in the initial assessment of the parties' rights and obligations. However, if the legal form indicates that the arrangement is a joint venture, the rights and obligations agreed to by the parties in their contractual arrangements must be evaluated for either consistency with the legal form of the separate vehicle, or to ascertain whether they reverse or modify the rights and obligations conferred by the legal form of the separate vehicle. Other facts and circumstances should also be considered as required by IFRS 11.

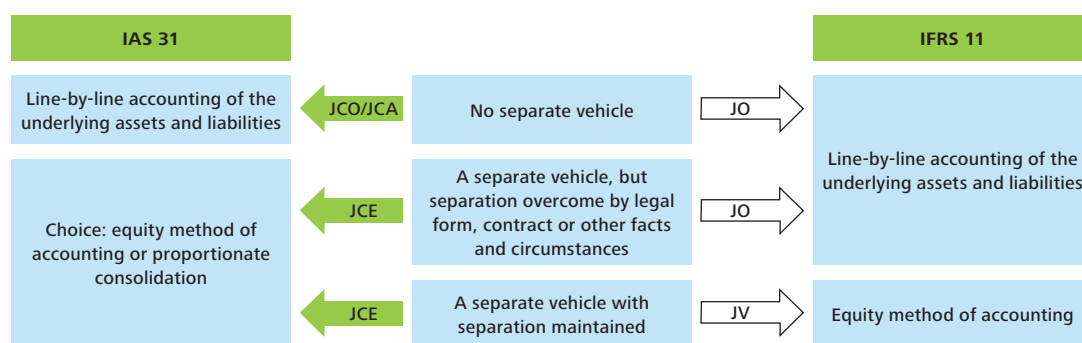
#### What are the accounting implications of joint arrangement classification?

One of the most significant effects of the new standard relates to the accounting for joint arrangements. Whilst the accounting for joint operations remains similar to that prescribed under IAS 31, such that a joint operator accounts for its share of assets, liabilities, revenues, and expenses on a line by line basis in accordance with the applicable IFRSs, the accounting choice of proportionate consolidation for joint ventures under IAS 31 has been removed. IFRS 11 requires the use of the equity method for interests in joint ventures.

Life science entities that have previously accounted for their interests in jointly controlled entities (JCEs) using proportionate consolidation will need to reassess the classification and accounting of these interests.

The following chart illustrates the differences between the joint arrangement classification and accounting models of the existing IAS 31 and the recently issued IFRS 11:

**Figure 2. Accounting comparison to IAS 31**



**Key:**  
 JCO/JCA: Jointly controlled operation/jointly controlled asset  
 JCE: Jointly controlled entity  
 JO: Joint operation  
 JV: Joint venture

Life science entities that have previously accounted for their interests in jointly controlled entities (JCEs) using proportionate consolidation will need to reassess the classification and accounting of these interests.

#### Change from proportionate consolidation to equity method of accounting

Those entities that change from proportionate consolidation to the equity method will present a single net investment balance and single result as compared to a line by line presentation.

Summarising some of the key impacts of a change from proportionate consolidation to the equity method within the financial statements:

**Table 1. Effects of ceasing proportionate consolidation**

| Statements   |  |
|--|--|
| Statement of financial position                      | <ul style="list-style-type: none"> <li>Tangible and intangible assets and liabilities will be reduced as the line by line presentation of the venturers' share of the tangible assets, intangible assets, other assets, and liabilities is replaced by a single net investment amount.</li> <li>Equity may increase if the venture is in a net liability position. Under the equity method of accounting, if an investor's share of cumulative losses in the joint venture exceeds its interest in the joint venture, then unless they have a legal or constructive obligation to fund the deficit, the investor discontinues recognising its share of further losses. Under proportionate consolidation, the investor would continue to recognise its share of the losses in profit or loss.</li> </ul> |
| Statement of profit or loss and comprehensive income | <ul style="list-style-type: none"> <li>Reported figures will decline to the extent of the entity's previously recognised share of revenue and expenses of the joint venture. Accordingly, total revenues and total expenses will decrease though there will not generally be a change to total profit.</li> <li>Other metrics may increase or decrease depending on the results of the joint arrangement relative to the group. For example, profit or loss before tax may decrease if the joint venture has a tax expense as this would now be recorded in the venturer's pre-tax results.</li> </ul>   |
| Statement of cash flows                              | <ul style="list-style-type: none"> <li>Reported operating, investing, and financing cash flows will decline to the extent of the previously recognised share in the cash inflows of the joint venture.</li> </ul>  |



The nature and extent of {accounting} differences {between IFRSs and U.S. GAAP} would depend on whether the joint operation involves a separate legal entity.

### Change from proportionate consolidation to accounting for individual assets and liabilities

Entities that previously accounted for their interests in JCEs using proportionate consolidation and subsequently determine that classification as a joint operation under IFRS 11 is appropriate (requiring the joint operator to recognise its share of assets, liabilities, revenues, and expenses on a line by line basis) may also be affected.

The IASB described one potential difference between recognising assets, liabilities, revenues, and expenses relating to the activity of the joint operation and proportionate consolidation in the Basis for Conclusions to IFRS 11. It relates to the fact that the rights and obligations, as specified in the contractual arrangement, that an entity has with respect to the assets, liabilities, revenues, and expenses relating to a joint operation might differ from its ownership interest in the joint operation. IFRS 11 requires an entity with an interest in a joint operation to recognise assets, liabilities, revenues, and expenses according to the entity's shares in the assets, liabilities, revenues, and expenses of the joint operation as determined and specified in the contractual arrangement, rather than basing the recognition of assets, liabilities, revenues, and expenses on the ownership interest that the entity has in the joint operation.

#### Observation

For joint operations (including former JCOs, JCAs and, potentially, some former JCEs), an entity recognises its assets, liabilities, revenues and expenses, and/or its relative share of those items. Many incorrectly refer to the accounting for joint operations as 'proportionate consolidation'. However, as discussed above, these two methods are technically different. Many joint operators may find there is not a material difference in their consolidated financial statements between the accounting for a joint operation and proportionate consolidation in practice, particularly when a joint operator has rights to all assets and obligations for all liabilities in the same proportion. However, rights to assets and obligations for liabilities in different proportions may result in differences between line-by-line accounting and proportionate consolidation.

### A comparison to U.S. GAAP

The issuance of IFRS 11, and particularly the elimination of proportional consolidation, has further aligned the accounting for joint arrangements under IFRSs with that under U.S. GAAP. While the term "joint arrangement" is not defined in U.S. GAAP, the accounting for certain arrangements under U.S. GAAP may still be similar to that under IFRSs. For example, a joint arrangement accounted for as a joint venture under IFRS 11 would typically be treated identically under U.S. GAAP (i.e., under the equity method).

However, an arrangement accounted for as a joint operation under IFRS 11 would most likely be treated differently under U.S. GAAP. The nature and extent of these differences would depend on whether the joint operation involves a separate legal entity.

- **A separate entity accounted for as a joint operation under IFRSs would typically be accounted for as an equity method investment under U.S. GAAP.** IFRS 11 requires that certain interests in jointly controlled entities be accounted for as joint operations. In effect, the legal entity is disregarded and an investor reflects its share of the joint operation line by line in its financial statements. There is no equivalent accounting treatment under U.S. GAAP; as a result, any investment in a jointly controlled entity would ordinarily be subject to the equity method of accounting, resulting in a single line-item presentation of the interest in the balance sheet and income statement.
- **In the absence of a separate entity, the financial statement presentation and classification of the joint operation under IFRSs may still differ from those under U.S. GAAP.** IFRS 11 requires line-by-line recognition of the investor's share of the joint operation's assets, liabilities, revenues, and expenses. Under U.S. GAAP, there is no specific guidance on jointly controlled assets outside of a legal entity; however, U.S. GAAP guidance on collaborative arrangements does contain specific requirements affecting income statement classification for collaborative arrangements that are not primarily conducted through a legal entity. The guidance requires, in part, that participants to a collaborative arrangement consider the revenue recognition principal-agent criteria when evaluating the reporting for costs incurred and revenue generated from transactions with third parties. For sales to third parties, for example, a participant would record the amounts gross if it was the principal in the sales transaction.

#### Observation

Under both IFRSs and U.S. GAAP, an investor must reflect – whether under the equity method or otherwise – its contractual interest in the economic results of the joint arrangement. However, the above items could result in material differences in the classification and presentation throughout the financial statements and could ultimately affect the deal structure desired by the parties to a joint arrangement.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 200,000 professionals, all committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the “Deloitte Network”) is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2013. For information, contact Deloitte Touche Tohmatsu Limited.

Designed and produced by The Creative Studio at Deloitte, London. 25245A