

IFRS industry insights

The new joint arrangements standard – insights for the real estate industry



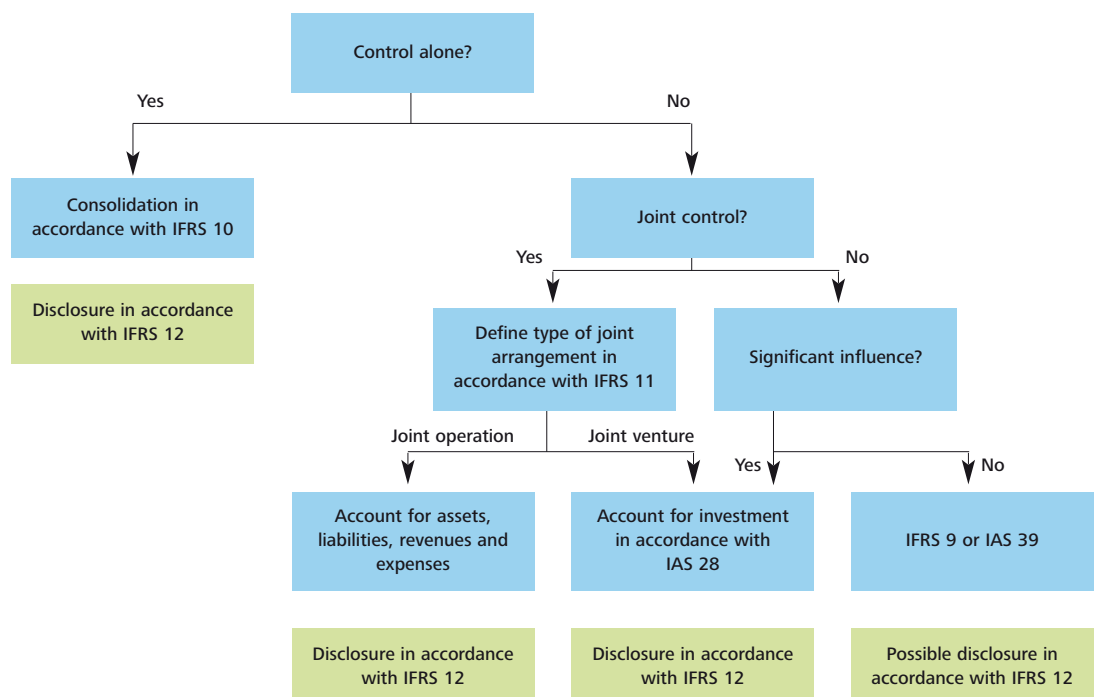
IFRS 11 *Joint Arrangements* may change how investors in the real estate industry account for their interests in joint arrangements.

The International Accounting Standards Board's (IASB) recently issued joint arrangements standard, IFRS 11 *Joint Arrangements*, supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*, may change how investors in the real estate industry account for their interests in joint arrangements. Concurrent with the issuance of IFRS 11, the IASB also issued:

- IFRS 10 *Consolidated Financial Statements*;
- IFRS 12 *Disclosure of Interests in Other Entities*;
- IAS 27 *Separate Financial Statements* (2011) which has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (2011) which has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

These standards are effective for annual periods beginning on or after 1 January 2013.

The interaction amongst the new standards is summarised below:



However, in a change from IAS 31, an arrangement that includes a separate legal vehicle is not precluded from being considered a joint operation or joint venture.

IFRS 11 and IFRS 12 may have a significant effect on the accounting for joint arrangements in the real estate industry. Joint arrangements are commonplace in the real estate industry for various reasons, for example, as a means of sharing risk, raising finance or bringing in additional expertise. IFRS 11 may change the classification and accounting for existing joint arrangements. Furthermore, IFRS 12 will require additional disclosures in the financial statements relating to an entity's interests in joint arrangements.

This Industry Insight publication highlights many of the issues the real estate industry is likely to encounter in adopting IFRS 11 and IFRS 12 and provides insight and examples to assist in the implementation of the new standards.

Definition of 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.

Observation

IFRS 11 provides guidance for determining if 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, if two parties establish an arrangement in which each has 50 per cent of the voting rights 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, not all parties to the arrangement need to share control over the arrangement for it to be considered a joint arrangement. IFRS 11 provides the following example to illustrate this point.

Assume an arrangement has three parties: 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.

Joint operation versus joint venture

IFRS 11 classifies joint arrangements into two types – joint operations and joint ventures. The key distinguishing factor between the two types of arrangements is based on 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. The type of joint arrangement becomes increasingly important under IFRS 11 because the accounting for joint ventures and joint operations will always differ.

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 individual obligations for the 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.

However, in a change from IAS 31, an arrangement that includes a separate legal vehicle is not precluded from being considered a joint operation or joint venture. Because IFRS 11 places less emphasis on the legal form of the joint arrangement, an analysis of all relevant facts and circumstances may be required in determining whether the vehicle should be considered in its own right and therefore considered a joint venture or a joint operation.

... a joint arrangement that limits the liability of the parties 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 limited liability.

IFRS 11 provides the following guidance on factors to consider in the identification of a joint venture:

Legal form of the separate vehicle

A joint arrangement that is conducted through a separate vehicle may offer the investors no limitation on the liability of the parties to that arrangement. This indicates that the joint arrangement is a joint operation. However, a joint arrangement that limits the liability of the parties 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 limited liability.

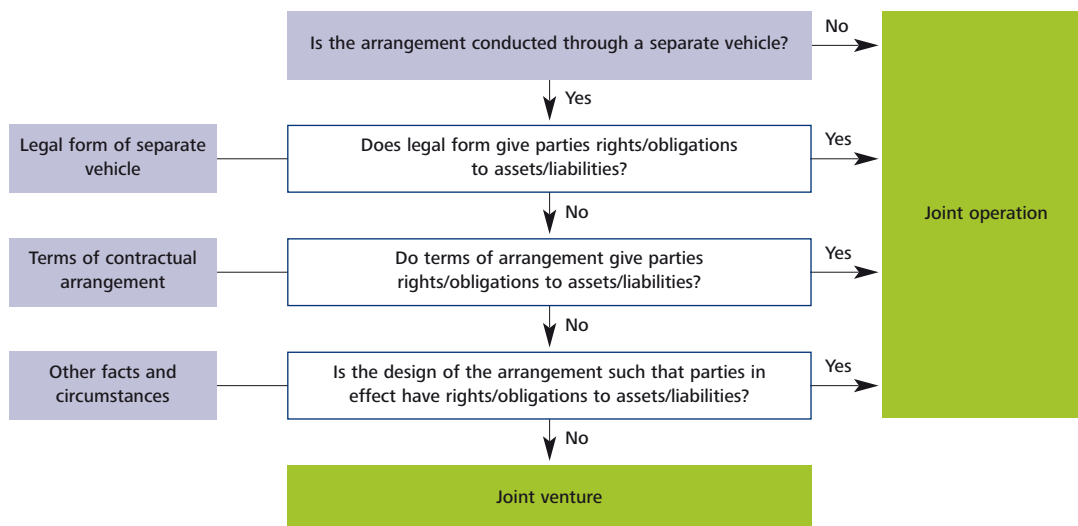
Terms of the contractual arrangement

Contractual arrangements between the parties to the joint arrangement may counteract 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 shelter the investors from having a direct obligation for its liabilities. 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.

Other facts and circumstances

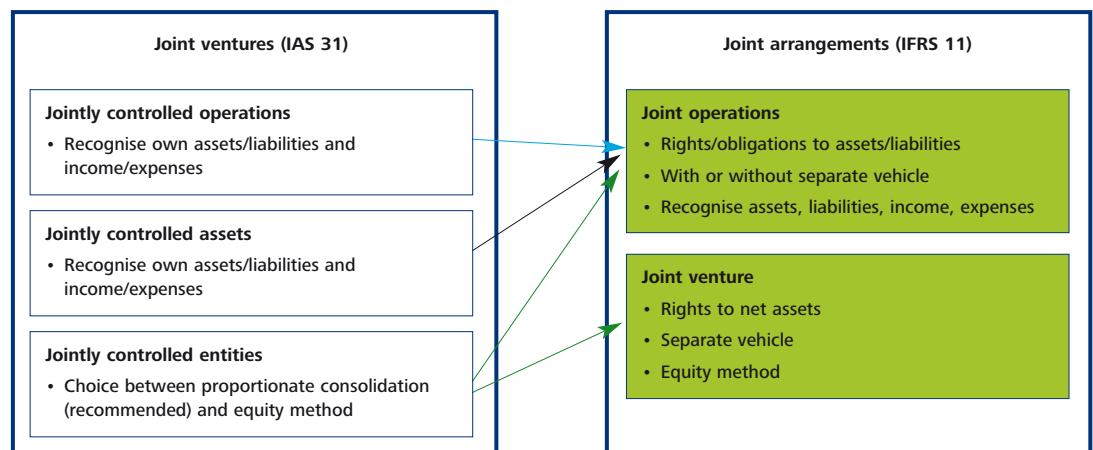
When a separate vehicle is used and the terms of the contractual arrangement do not indicate that the joint arrangement is a joint operation, the parties should consider any other relevant facts and circumstances in determining the type of arrangement. For example, if a separate vehicle is formed to hold the assets and liabilities of the joint arrangement, the parties involved have rights to substantially all of the arrangement's economic benefits (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 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.

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



... a party that holds an interest in, and jointly controls an incorporated entity that is used to hold real estate assets, may have rights to the net assets of the entity or rights to the assets and obligations for the liabilities held in the entity.

The comparative application of these descriptions to joint venture arrangements is set out below:



In the real estate industry, a party may hold an interest in and jointly control a real estate asset through an unincorporated joint venture. An arrangement established through an unincorporated legal entity which enables the parties to have rights to the asset and obligations for the associated liabilities would be considered a joint operation under IFRS 11. This is consistent with the existing practice of accounting for unincorporated joint ventures.

Conversely, a party that holds an interest in, and jointly controls an incorporated entity that is used to hold real estate assets, may have rights to the net assets of the entity or rights to the assets and obligations for the liabilities held in the entity. Judgement may be required to determine if the joint arrangement is a joint venture or joint operation. If the terms of the arrangement or other facts and circumstances indicate that the parties have rights to the assets and liabilities for the obligations of the incorporated entity, each party would account for its interest as an interest in a joint operation even though a separate legal entity was used.

Observation

There may be several arrangements within a single vehicle or master contract agreement where parties have different rights to the assets and obligations for the liabilities. Although these joint arrangements are governed under the same framework agreement, if the parties' rights and obligations differ, the type of joint arrangement may differ.

For example, assume an arrangement exists with multiple parties holding an equity interest in a legal entity which maintains a building for rental purposes. Each party is assigned a floor of the building and can use the assigned floor at their discretion. The remaining floors not specifically assigned to a party are for rental purposes, with net profits shared amongst the parties based on their equity interests.

In this situation, each party should determine whether the rights and obligations relating to its direct interest (i.e., interest in a single floor) differ from those relating to the remaining portion of the building excluding the floors assigned to each party individually.

The following example is adapted from example 2 of IFRS 11:

Facts

Real estate companies A and B (collectively, the parties) set up a separate vehicle (entity X) for the purpose of acquiring and operating a shopping centre. The contractual arrangement between the parties establishes joint control of the activities that are conducted in entity X. The main feature of entity X's legal form is that the entity, not the parties, has rights to the assets, and obligations for the liabilities, relating to the arrangement. These activities include the rental of the retail units, managing the car park, maintaining the centre and its equipment, such as lifts, and building the reputation and customer base for the centre as a whole. The terms of the contractual arrangement are such that:

- entity X owns the shopping centre. The contractual arrangement does not specify that the parties have rights to the shopping centre;

IFRS 11 requires the use of the equity method of accounting for interests in joint ventures.

- b) the parties are not liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of companies A and B to any third party will be limited to the unpaid amount of that company's capital contribution;
- c) the parties have the right to sell or pledge their interests in entity X;
- d) each party receives a share of the income from operating the shopping centre (which is the rental income net of the operating costs) in accordance with its interest in entity X.

Conclusion

The joint arrangement is carried out through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, relating to the arrangement. Instead, the terms of the contractual arrangement establish that the parties have rights to the net assets of entity X.

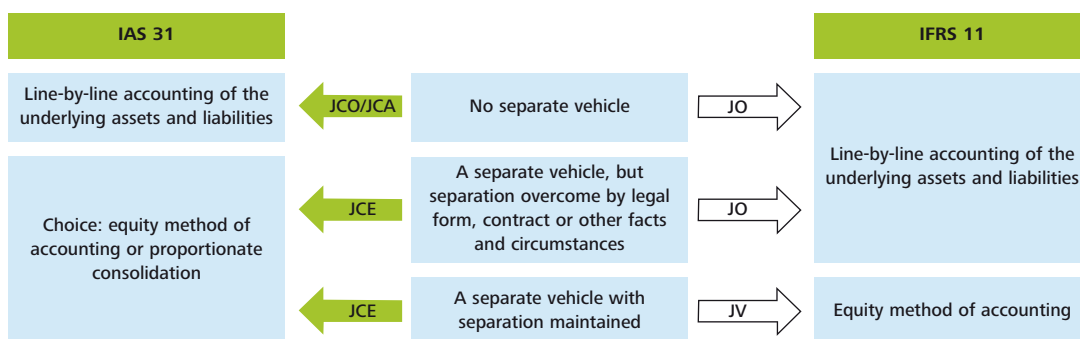
On this basis, there are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets relating to the arrangement, and that the parties have an obligation for the liabilities relating to the arrangement. The joint arrangement is a joint venture. A and B recognise their rights to the net assets of entity X as investments and account for them using the equity method of accounting.

However, a change in certain facts may result in a different conclusion. For example, assume that the contractual arrangement between companies A and B establishes that the parties have rights to all the assets necessary to undertake the activities of the arrangement and that the parties are liable in respect of the debts, liabilities or obligations of entity X. If entity X is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of companies A and B to any third party will not be limited to the unpaid amount of that company's capital contribution. In this situation, the parties may conclude that the terms of the contractual arrangement result in the parties having rights to the assets and obligations for the liabilities of entity X. However, all facts and circumstances will need to be considered.

Accounting

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 of accounting for interests in joint ventures. This change will affect many companies in the real estate industry, for example, jointly owned shopping centres currently treated as jointly controlled entities and proportionally consolidated will have to be accounted for using the equity method if they are classified as joint ventures under IFRS 11.

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:



Key:

JCO/JCA: Jointly controlled operation/jointly controlled asset

JCE: Jointly controlled entity

JO: Joint operation

JV: Joint venture

Real estate entities that have previously accounted for their interests in jointly controlled entities using proportionate consolidation will need to reassess the classification and accounting of these interests that are classified as joint ventures under IFRS 11.

Real estate entities that have previously accounted for their interests in jointly controlled entities using proportionate consolidation will need to reassess the classification and accounting of these interests that are classified as joint ventures under IFRS 11. Those entities that change from proportionate consolidation to the equity method of accounting will present a single net investment balance and single result as compared to a line by line presentation. Therefore, revenues and expenses will decrease as the venturers will not present their share of the joint ventures' revenue and expenses as part of their own revenue and expenses. Additionally, 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.

Also, the elimination of the option to apply proportionate consolidation will affect those joint ventures that are 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.

Example:

- A joint venture was set up between parties A and B in January 2010, with net assets of CU 200m.
- Each party has a 50 per cent interest in the net assets of the joint venture and neither party has an obligation to fund the joint venture if it enters into a deficit position.
- In 2010, the joint venture incurred a loss of CU (100m), with net assets reduced to CU 100m.
- In 2011, the joint venture incurred a loss of CU (150m), resulting in net liabilities of CU (50m).
- In 2012, the joint venture incurred a loss of CU (200m), with the net liabilities increasing to CU (250m).
- The parties chose to apply proportionate consolidation to their interest in the joint venture under IAS 31.

The following illustrates the financial statement effect of changing from applying proportionate consolidation to applying the equity method of accounting:

Proportionate consolidation			
Each party's share of the results of the joint venture would be recognised on a line by line basis as follows:			
	2010	2011	2012
Profit and loss	Loss of CU 50m	Loss of CU 75m	Loss of CU 100m
Statement of financial position	Net assets of CU 50m	Net liabilities of CU 25m	Net liabilities of CU 125m

Equity method of accounting			
Each party's share of results would be recognised on a single line as follows:			
	2010	2011	2012
Profit and loss	Loss of CU 50m	Loss of CU 50m	N/A
Statement of financial position	Investment of CU 50m	Investment of nil	Investment of nil

In applying the equity method of accounting, if the joint venture were to return to profitability, each party would commence recognising their share of the profits only after its share of the profits equals the share of losses not recognised.

There are a number of other accounting consequences when applying the equity method of accounting rather than proportionate consolidation. For example:

- Under the equity method of accounting, the elimination of transactions between the investor and the joint venture is often limited to unrealised profits, whereas all such transactions are eliminated using proportionate consolidation (to the extent of the investor's interest in the joint venture).
- Amounts owed by a venturer to a joint venture, and vice versa, are not eliminated under the equity method of accounting, whereas those amounts are eliminated using proportionate consolidation (to the extent of the investor's interest in the joint venture).

An entity should disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence, and the type of joint arrangement where the arrangement has been structured through a separate vehicle.

Observation

An entity that changes from the equity method of accounting to line-by-line accounting of the underlying assets and liabilities will need to identify and recognise the assets it controls and the liabilities for which it has obligations. This process may be challenging and time consuming. For example, assume a joint arrangement is established where two parties share a specific portion of the properties subsequent to development. The parties agree to share the project returns, where one party receives the returns of the commercial portion of the property while the other party receives the returns of the residential portion of the property. Determining the split of assets and liabilities will often require a detailed review of the contract terms.

Comparatives

IFRS 11 is effective for annual periods beginning on or after 1 January 2013. If the adoption of IFRS 11 requires a change in accounting, the comparative period will require restatement. This would be the case in two circumstances:

Before (IAS 31)	After (IFRS 11)	As of beginning of first comparative period
Jointly controlled entity Equity method of accounting	Joint operation	<ol style="list-style-type: none"> 1. Derecognise the equity method investment 2. Recognise assets (incl. goodwill) and liabilities 3. If net assets recognised < equity method investment → reduce goodwill (if any) with any excess against retained earnings 4. If net assets recognised > equity method investment → difference against retained earnings
Jointly controlled entity Proportionate consolidation method	Joint venture	<ol style="list-style-type: none"> 1. Derecognise assets (incl. goodwill) and liabilities 2. Recognise equity method investment 3. Perform impairment loss test on opening balance of investment and impairment loss, if any, recognised as adjustment of retained earnings

Disclosures

IFRS 12 provides disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. The objective of IFRS 12 is to require disclosure that helps users of financial statements evaluate:

- the nature of, and risks associated with, an entity's interests in other entities; and
- the effect of those interests on the entity's financial position, financial performance and cash flows.

An entity that has an interest in one or more other entities should disclose the following:

- Significant judgements and assumptions: An entity should disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence, and the type of joint arrangement where the arrangement has been structured through a separate vehicle (joint operation or joint venture).
- Interests in joint arrangements (and associates): An entity should disclose information about the nature, extent and financial effects of its interests in joint arrangements, including information about contractual relationships with the other parties to the joint arrangements. An entity should also disclose the nature of, and changes in, the risks associated with its interests in joint arrangements.

IFRS 12 requires that for each material interest, the information would be provided separately. However, it also permits aggregation of some information within each class of entity, so long as the level of detail provided through disclosures satisfies the needs of the users of the financial statements but does not result in excessive detail. It outlines that consideration should be given to both qualitative and quantitative information about the risks and returns of each entity when considering the level of aggregation.

Observation

The required disclosure of judgements and assumptions for interests in joint arrangement and associates is based on the existing requirements under paragraph 122 of IAS 1 *Presentation of Financial Statements*. IFRS 11's increased use of judgement may translate into significantly increased disclosures relating to joint arrangements under IFRS 12. Entities will need to collate the required information for each joint arrangement and determine the appropriate level of aggregation of information such that the disclosures are not excessive but still provide users with the necessary information.

Other considerations

- Internal information systems: Real estate entities may need to review their internal information systems to determine if there is a need to modify their internal systems and processes to gather necessary information to comply with new disclosure requirements.
- Performance: Real estate entities should consider the implications of the change in the presentation of financial results on key performance indicators (e.g., leverage ratios, gross margin ratios, return on assets ratios), debt covenants, existing contracts (e.g., remuneration agreements) and regulatory disclosures.
- Segment reporting: Real estate entities that move from proportionate consolidation to the equity method of accounting should consider the affect of IFRS 11 on internal management reporting and the way management views the business and makes strategic and operating decisions. IFRS 8 *Operating Segments* requires disclosure of segment information on the same basis as it is provided to the company's chief operation decision maker (CODM). If the CODM is presented with information prepared using proportionate consolidation, that basis that would continue to be presented in the segment information but would need to be reconciled to the primary financial statements.
- New and existing contracts: Real estate entities will need to consider the affects of IFRS 11 as they negotiate new contractual arrangements and modify existing arrangements.
- Tax consequences: Impacts on consolidation conclusions and the presentation of joint arrangements may impact profit (loss) before tax, including the impact of IFRS 11 on presentation of a pre- or post-tax item. Entities will also need to consider if there are any further tax implications from adopting IFRS 11.
- Other accounting policy changes: Real estate entities should consider if there are accounting policies that are no longer required to be disclosed as a result of adoption.

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