No more proportionate consolidation

This new joint arrangements standard has, like the consolidation standard that it accompanies, been long in the making. The IASB started work on it in 2005. It did so for two reasons. First, there was the old standard’s exclusive focus on the structure of the arrangement: under the joint ventures standard, IAS 31, the presence of a separate vehicle determined the classification as between ‘jointly controlled entities’ and other arrangements. This led, in the IASB’s view, to what were economically similar arrangements being accounted for differently and vice versa.

Second, there was IAS 31’s free choice, for jointly controlled entities, between proportionate consolidation and the equity method. The IASB’s view is that proportionate consolidation is not appropriate in the absence of rights/obligations directly to/for the underlying assets/obligations of the arrangement.

On the other hand, in our experience many companies felt as though there was little substantive difference between their jointly controlled entities and other joint arrangements. These companies therefore appreciated being able to account for these arrangements in a similar fashion. The new standard on joint arrangements, IFRS 11, has removed that choice, and companies may now consider that what are in their view economically similar arrangements will be accounted for in different ways.

In order to determine which of equity accounting or proportionate accounting applies, IFRS 11 sets out tests that look not only at the existence of a separate vehicle but also goes some way to accounting for the substance. Its substance-basis, set out in specific tests, is necessarily somewhat limited. This does, however, make the standard less straightforward to apply than was IAS 31, even if it is not quite as complex as the new consolidation standard.

Overall then, IFRS 11 has gone some way to addressing what the IASB felt were the shortcomings of the old standard. We imagine, however, that its effects will prove unpopular in those sectors that use joint arrangements to a significant degree and in which the old proportionate consolidation option was extensively used. Under IFRS 11 we are likely to see some major effects whereby extensive activities, which were previously shown gross in the financial statements, now shrink down to a one-line basis – a change in the opposite direction from that intended by the companion standard on consolidation. With an implementation date of years beginning on or after 1 January 2013, companies will at least have some time to manage expectations among users of their accounts.

In the meantime, we trust that this publication will assist companies in understanding what needs to be done to apply the standard; and assist investors’ understanding of what is driving the different information that they will begin to see, in 2013, as companies begin to report on this basis.

Paul Munter
Mike Metcalf
Julie Santoro

KPMG’s global IFRS Business Combinations and Consolidation leadership team
KPMG International Standards Group
1. Overview

Under IFRS 11, joint arrangements are essentially defined in the same way as under IAS 31: Interests in Joint Ventures: an arrangement over which there is joint control. What is new is the way in which IFRS 11 sub-categorises joint arrangements into:

- **joint operations**, whereby the parties with joint control have rights to the assets, and obligations for the liabilities, relating to the arrangement; and
- **joint ventures**, whereby the parties with joint control have rights to the net assets of the arrangement and how it accounts for them.

The differences between the joint arrangement classification and accounting models of the existing IAS 31 and the new IFRS 11 can be illustrated as follows:

<table>
<thead>
<tr>
<th>IAS 31</th>
<th>IFRS 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Line-by-line accounting of the underlying assets and liabilities</td>
<td>Line-by-line accounting of the underlying assets and liabilities</td>
</tr>
<tr>
<td>Choice: equity accounting or proportionate consolidation</td>
<td>No separate vehicle</td>
</tr>
<tr>
<td>JCO/JCA</td>
<td>JO</td>
</tr>
<tr>
<td>JCE</td>
<td>A separate vehicle with separation maintained</td>
</tr>
<tr>
<td>JV</td>
<td></td>
</tr>
</tbody>
</table>

**Key**

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

Put simply, IFRS 11 does two things:

- First, it carves out, from IAS 31 jointly controlled entities, those cases in which, although there is a separate vehicle, that separation is ineffective in certain ways. These arrangements are treated similarly to jointly controlled assets/operations under IAS 31 and are now called joint operations.
- Second, the remainder of IAS 31 jointly controlled entities, now called joint ventures, are stripped of the free choice of using the equity method or proportionate consolidation; joint venturers must now always use the equity method.
2. How this could affect you

The main changes from IAS 28 *Investments in Associates* (2008), IAS 31 and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*, and the related potential impacts, are summarised below:

<table>
<thead>
<tr>
<th>Key changes</th>
<th>Potential impacts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>The structure of the joint arrangement is no longer the main factor in determining the accounting (see section 4)</strong></td>
<td>Notwithstanding the change in principles between IAS 31 and IFRS 11 as illustrated in the overview, we expect that in practice, many, but not all, jointly controlled entities under IAS 31 will be classified as joint ventures under IFRS 11. Although there may not be across-the-board change in classification, all joint arrangements will need to be re-assessed on transition to IFRS 11. As the classification of a joint arrangement requires identification and assessment of the structure, legal form, contractual arrangement and other facts and circumstances, this is expected to be an area of judgement that requires careful consideration in practice.</td>
</tr>
<tr>
<td><strong>A single method of accounting for joint ventures (see section 5)</strong></td>
<td>The transition from proportionate consolidation to the equity method will affect virtually all of an entity’s financial statement line items, notably decreasing revenue, gross assets and gross liabilities. If the joint venture is profitable and a taxable entity, then the transition will also decrease profit before tax as tax expenses of the joint arrangement will no longer be included in the tax line. As well as the above major presentational change, there may also be other consequential accounting effects resulting from the cessation of proportionate consolidation. For example, when a venturer has hedged a joint venture’s asset or liability (e.g. hedge of interest rate risk on the joint venture’s debt), there is no case for hedge accounting once equity accounting is applied. Similarly, a venturer’s interest expense may no longer be capitalised into a joint venture’s asset. This change is expected to be widespread as, in our experience, currently approximately half of the entities applying IFRSs use proportionate consolidation while the other half use the equity method to account for jointly controlled entities in a wide range of industries. However, the extractive and real estate industries are likely to be particularly affected by the new requirements because of the prevalence and sometimes complexity of the joint arrangements used. As a consequence of this transition, entities may need to: ● consider the effect on existing contracts, e.g. debt and remuneration agreements, and performance measures; and ● communicate the expected effects of transition to shareholders, including managing analysts’ expectations.</td>
</tr>
</tbody>
</table>
3. Identifying joint arrangements

3.1 Definition and two-step model

A joint arrangement is an arrangement over which two or more parties have joint control, being the contractually agreed sharing of control, i.e. unanimous consent is required for decisions about the relevant activities.

In order to identify a joint arrangement, IFRS 11 asks for a two-step analysis to be performed: (1) assess whether collective control exists of an arrangement; and (2) then assess whether the contractual arrangement gives two or more parties joint control over the arrangement.

Insight – Is the two-step method relevant in practice?

Naturally, joint control involves two things: control and that this control is joint. However, it is difficult to foresee circumstances in which IFRS 11’s collective control step is of practical relevance.

The two-step approach involves the identification of ‘collective control’ and then asks whether that control is joint. Collective control is not defined, but joint control is. It seems most efficient instead to approach a possible joint arrangement by asking this question, based solely on the definition of joint control: is there a contract whereby two (or more) parties are required to exercise together, on a unanimous consent basis, their powers in relation to an arrangement; and do those powers amount to control?

For example, suppose that three parties each have one third of the voting power in an entity and decisions are made by simple majority. If no shareholders’ contract exists, then the conclusion can be reached immediately that joint control does not exist. It seems quite unnecessary to consider, first, whether any two of the three parties might have collective control.

Conversely, if a shareholders’ contract exists, then an immediate analysis can be made of whether it requires unanimous consent (whether of two specific shareholders or all three) for the casting of controlling votes on relevant activities. In practice the substantive issue has always been, and remains, whether any unanimous consent requirement extends to sufficient matters such that joint control, rather than sole control, exists.

What follows in the remainder of section 3 does, however, set out the IFRS 11 two-step model so that this publication may be used as a companion to IFRS 11.

3.2 What is control?

Under IFRS 10 Consolidated Financial Statements, an investor controls an investee when it is exposed, or has rights to variable returns from its involvement with that investee and has the ability to affect those returns through its power over the investee.
Insight – Changes to the definition of control

IFRS 10 formalises concepts such as:

- consolidation when the investor holds less than half of the voting rights but holds voting rights sufficient unilaterally to direct the relevant activities of the investee, i.e. de facto control; and
- consolidation of part of an entity when the investor has control over specified, ring-fenced assets and liabilities of an entity and therefore treats that portion of the entity as a deemed separate entity (silo).

It appears that those concepts may have some relevance for joint arrangements; if the arrangements that may be subject to control are now wider, then why could that control not also be joint? However, IFRS 10 is not clear as to the precise boundaries of these concepts and an assessment of joint control might be especially difficult in these situations. These concepts, in the context of IFRS 10, are discussed further in our publication First Impressions: Consolidated financial statements.

Main change from IAS 31

IFRS 11 does not introduce substantive changes to the overall definition of an arrangement subject to joint control, although the definition of control, and therefore indirectly of joint control, has changed due to IFRS 10. In general, we expect that arrangements that were considered to be jointly controlled under IAS 31 will also be considered joint arrangements under IFRS 11 and vice versa. However, due to the change in the definition of control, occasional scenarios may exist in which an arrangement that was not within IAS 31 is within IFRS 11 and vice versa.

3.3 Is the control joint?

3.3.1 Definition of joint control

Joint control is the contractually agreed sharing of control of an arrangement. Joint control exists only when decisions about the relevant activities, i.e. those that significantly affect the returns of the arrangement, require the unanimous consent of the parties sharing the control of the arrangement. Therefore, decisions relating to fundamental changes in the activities of the arrangement or applying only in exceptional circumstances (i.e. protective rights) are not considered in this assessment.

An enforceable contractual arrangement can be evidenced in several ways, but it is often in writing and usually in the form of a contract or documented discussions between the parties. Statutory mechanisms can also create enforceable contractual arrangements on their own or in conjunction with contracts between parties.

The contractual arrangement sets out the terms on which the parties participate in the activity that is the subject of the joint arrangement and generally deals with matters such as:

- the purpose, activity and duration of the joint arrangement;
- the governing body’s members’ appointment process;
- the decision-making process;
- the capital or other contributions required of the parties; and
- the sharing of assets, liabilities, revenues, expenses and profits or losses arising from the joint arrangement.

For joint arrangements structured through a separate vehicle, at least some aspects of the contractual arrangement may be incorporated in the articles of association, charter or by-laws of that vehicle.
In practice, the contractual arrangement may include clauses on the resolution of disputes, such as arbitration, so that decisions can be made in the absence of unanimous consent of the parties that have joint control. However, the existence of such clauses does not automatically preclude the arrangement from being assessed as a joint arrangement.

The assessment of joint control requires judgement and consideration of all facts and circumstances. A change in the facts and circumstances will require re-assessment of whether joint control still exists.

In a joint arrangement, any party with joint control can prevent any of the other parties from making unilateral decisions without its consent. However, not all parties to the arrangement need to share control over the arrangement for it to be considered a joint arrangement. IFRS 11 specifies the accounting not only for those parties that have joint control (see section 5), but also for those parties that participate in, but do not have joint control over, the arrangement (see section 6).

**Insight – Control is joint only when contractual**

Joint control exists only when it is contractually agreed that decisions about the relevant activities require the unanimous consent of the parties that control the arrangement collectively. When, for example, the parties can demonstrate past experience of voting together in the absence of a contractual agreement to do so, this will not satisfy that requirement. In other words, a de facto joint control is not possible. However, it is possible for parties to establish joint de facto control, i.e. the control is based on de facto circumstances and the parties sharing that control have contractually agreed to share that control. This issue is discussed further in our publication First Impressions: Consolidated financial statements.

For example, Company X holds 23 percent of the voting rights of Company Z and Company Y holds 25 percent of the voting rights. The remaining voting rights are held by thousands of shareholders, none individually holding more than 1 percent of the voting rights. X and Y have contractually agreed that on decisions about the relevant activities of Z, the casting of their combined 48 percent voting power requires their unanimous consent. None of the other shareholders has any arrangements to consult each other or make collective decisions. This example is identical to that at paragraph B43 of IFRS 10, except that in IFRS 10 there is sole control over casting of the 48 percent bloc and here there is joint control over it. In IFRS 10 it is concluded in this scenario, on the basis of the absolute size of its holding and the relative size of the other shareholdings, that the sole controller of the 48 percent bloc controls Z. Similarly, in this scenario, X and Y have joint control over Z.

**Insight – Significant disparity in holdings**

Although the contractual arrangement may require the unanimous consent of the parties that control the arrangement collectively, in our view a significant disparity in holdings may require some caution in assessing whether joint control exists. For example, consider an arrangement in which one party holds 75 percent and another party holds 25 percent. The significant disparity in holdings may indicate that joint control does not exist, as it is unlikely that a party holding 75 percent of the arrangement would accept the sharing of control of the arrangement. This issue is discussed in our publication Insights into IFRS (3.5.110.20).

**Insight – Protective vs other rights**

The distinction between protective rights and other rights (commonly but not officially known as participative rights) did not exist in IAS 27 Consolidated and Separate Financial Statements (2008) and IAS 31. Although more clarity is provided in IFRS 10, in practice we do not expect a change in classification of a joint arrangement in relation to this. This issue is discussed further in our publication First Impressions: Consolidated financial statements.
Insight – Dispute resolution

In our view, for joint control to exist, dispute resolution procedures should be neutral and not favour one of the parties: for example, a mutually agreed on independent arbitrator should be used. This issue is discussed in our publication *Insights into IFRS* (3.5.120.10).

Main change from IAS 31

Although the definition of a joint arrangement in IFRS 11 and its predecessor in IAS 31 are not identical, generally we do not expect significant changes to the evaluation of whether the control is joint in arrangements that are in the scope of the two standards. This is because the essential characteristics of a joint arrangement, i.e. a contractual agreement that requires unanimous consent among the joint controllers, remain unchanged. However, differences in the definition of control in IFRS 10 and IAS 27 (2008) could result in different conclusions in practice.

Although we do not expect changes to the identification of a joint arrangement, the following should be noted:

- Joint control has, in the first place, to meet the IFRS 10 definition of control.
- IFRS 11 provides more clarity as to the type of decisions that require the unanimous consent of the parties in order to determine that joint control exists, i.e. decisions about the relevant activities, while protective rights are ignored.

3.3.2 Joint vs collective control: the IFRS 11 two-step model

IFRS 10 is applied at the first step of the analysis to assess whether the parties, or a group of parties, when considered collectively, control the arrangement. All the parties, or a group of parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement, i.e. the relevant activities as defined in IFRS 10.

If such control exists, then the second step of the analysis is performed. If such control does not exist, then that arrangement is not within the scope of IFRS 11.

Example – Applying the two-step process

Assumption: 75 percent of the votes are required to make decisions about the relevant activities of the arrangement.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>The parties to the arrangement hold</th>
<th>Step 1 – Does collective control exist?</th>
<th>Step 2 – Does joint control exist?</th>
<th>Is it a joint arrangement?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>A-50% B-30% C-20%</td>
<td>Yes – A and B must act together to direct the relevant activities.</td>
<td>Yes – implicitly no decisions about the relevant activities of the arrangement can be made without both A and B agreeing.</td>
<td>✓</td>
</tr>
</tbody>
</table>
Scenario 1 illustrates that unanimous consent over the relevant activities can be implicit, i.e. the disposition of voting power among the parties may mean that the unanimous consent of specific parties is always required even though there is no shareholders’ agreement provision explicitly so stating. This is a common occurrence when two parties each have 50 percent of the voting rights and the contractual arrangement requires that the decisions about the relevant activities must be passed by simple majority, i.e. 51 percent.

Scenario 2 illustrates that collective control is not always joint control. In this scenario, A and B or alternatively A and C might be said to have collective control over the arrangement as one of the combinations of parties must act together to direct the relevant activities of the arrangement. Unless a contractual arrangement specifies which combination of parties is required to make unanimous decisions about the relevant activities, this arrangement is not a joint arrangement.

**Insight – Joint control vs collective control**

This step of the analysis seeks to differentiate between collective control and joint control. IFRS 11 does not define collective control but, from the examples provided (and reproduced in the table above), collective control is a situation in which a group of parties, or all parties, must act together in order to direct the relevant activities of an arrangement.

As noted in 3.1, however, it seems unnecessary first to identify collective control. Although this is the analysis required, it is rarely likely to be necessary in practice. Instead we suggest that entities move straight to the question of whether any parties are contractually required to act together by unanimous consent and, if so, whether the matters on which they act together amount to control. For example, we believe that most entities would look at scenario 2 and be able to conclude immediately that there is no unanimous consent whatsoever and therefore no joint arrangement.
4. Classifying joint arrangements

4.1 Overview of the model

4.1.1 Two classifications

IFRS 11.6 Joint arrangements are divided into two types, each having its own accounting model (see section 5). Joint arrangements are classified as follows:

IFRS 11.15, 16

- A joint operation is a joint arrangement whereby the jointly controlling parties, known as the joint operators, have rights to the assets and obligations for the liabilities relating to the arrangement.

- A joint venture is a joint arrangement whereby the jointly controlling parties, known as the joint venturers, have rights to the net assets of the arrangement.

IFRS 11.14, B14 The key to determining the type of the arrangement, and therefore the subsequent accounting, is the rights and the obligations of the parties arising from the arrangement in the normal course of business.

IFRS 11.17 An entity determines the type of joint arrangement by considering:

- the structure
- the legal form
- the contractual arrangement
- other facts and circumstances.

Appendix B in IFRS 11 sets out the application requirements and certain tests for each of these.

IFRS 11.19 An entity re-assesses the type of joint arrangement if facts and circumstances change.
Drawing all of the appendix B tests together, the classification question can be summarised in a flowchart approach, as follows:

**Insight – Flowchart approach**

1. **Structure**
   - Is the arrangement structured through a vehicle that is separate from the parties? (see 4.2)
   - No
   - Yes

2. **Legal form**
   - Does the legal form of the separate vehicle give the parties rights to the assets and obligations for the liabilities of the arrangement? (see 4.3)
   - Yes
   - No

3. **Contractual arrangement**
   - Do the contractual arrangements give the parties rights to the assets and obligations for the liabilities of the arrangement? (see 4.4)
   - Yes
   - No

4. **Other facts and circumstances**
   - Do the parties have rights to substantially all of the economic benefits of the assets relating to the arrangement; and does the arrangement depend on the parties on a continuous basis for settling its liabilities? (see 4.5)
   - Yes
   - No

Sections 4.2 to 4.5 cover each step in the flowchart in turn. In the remainder of 4.1 we make some overall observations about the model and the IFRS 11 approach.

**Insight – Definitions vs flowchart**

The above flowchart is adapted from a flowchart appearing in appendix B, which contains the specified tests for the application of the definitions included in IFRS 11. Although definitions are given, they seem to serve only to outline the concepts and it is the specified tests that are relevant for the practical application of IFRS 11; therefore, appendix B describes a dividing line, though not a bright line, between joint ventures and joint operations.

It is fortunate that IFRS 11 defers to the appendix B tests, as the concepts may raise application questions in practice. The concept is a distinction between direct access/exposure to each individual underlying asset and liability (i.e. a joint operation) and exposure only to the net result of the assets and liabilities (i.e. a joint venture). In some situations, as noted in the following example, the two may not be very widely separated as a matter of their commercial effect.
For example, a joint arrangement consists of a company that holds and develops a property and has a bank loan financing that development. The loan is guaranteed by the joint controllers (two property companies). When the development is complete, it will be sold in the market, the loan will be repaid, the surplus distributed to the joint controllers and the company wound up. The guarantee might seem to give responsibility for the liabilities of the arrangement to the joint controllers, who are also exposed to the property development risk in a similar way to conducting it without the benefit of a corporate wrapper.

Without considering the appendix B tests, it seems difficult to conclude in this case whether the parties have rights to assets and obligations for the liabilities of the arrangement, or whether they have rights to the net assets of the arrangement (which is the case in this instance – see 4.4).

**Insight – Broad thrust of the flowchart approach**

Appendix B looks first at whether there is a separate structure or legal entity. If there is not, then that in itself is definitive that it is a joint operation.

If there is a separate structure, then it looks at, broadly, whether any of the legal form of the structure, the contractual terms or other facts and circumstances make that separation ineffective.

We expect that these tests will be the central focus for application of IFRS 11 and may be an area requiring judgement.

**Insight – Emphasis on both assets and liabilities**

In the tests, it is rights to the assets and obligations for the liabilities relating to the arrangement that are being considered. A party has rights to the assets when, for example, it has rights, title or ownership in the individual assets of the arrangement. A party has obligations for liabilities when, for example, it is liable to third parties for individual liabilities; the standard makes clear that guarantees are not treated as achieving that (see 4.4). The standard seems to be trying to distinguish between:

- a single right/exposure to the net result of the arrangement’s assets and liabilities, i.e. a joint venture; and
- separate rights/exposures to the individual assets and liabilities of the arrangement, i.e. a joint operation.

Only when the parties have both rights to the assets and obligations for the liabilities, rather than either, is an arrangement within a separate vehicle a joint operation. Based on this, it is assumed that when the parties have only rights to assets, without obligations for liabilities, or vice versa, the joint arrangement will be determined to be a joint venture. However, from a practical and economic point of view, we would assume that generally parties to joint arrangements that have rights to the assets will typically have obligations for the liabilities, and parties to joint arrangements that have obligations for the liabilities will ensure that they have rights to the assets.
Main change from IAS 31

The term ‘joint arrangement’ in IFRS 11 replaces the term ‘joint venture’ as used in IAS 31 as a broad description of all arrangements in which two or more parties have joint control; the term ‘joint venture’ in IFRS 11 describes a sub-set of such arrangements.

The following diagram illustrates the changes in terminology from IAS 31 to IFRS 11:

IAS 31 used only a legal entity or structure-based distinction between its jointly controlled entities and all other joint ventures, which were previously called jointly controlled assets/operations. IFRS 11 carves out from that structure-based population, i.e. from jointly controlled entities, those arrangements in which the separation (of the joint controllers, from the assets and liabilities of the legal entity) is overcome by the legal form, contractual terms or other facts and circumstances. It treats this carved out population in the same way as arrangements in which there is no separate structure at all.

We expect that the tests, save for the very first step (i.e. existence of a separate structure) will not always be simple to apply. In contrast, the IAS 31 test was very straightforward. However, given that the IASB wanted to get away from a purely structure-based test, it was inevitable that it would move away from such an approach.

4.1.2 The unit of account

The unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly. A party assesses its rights to the assets and obligations for the liabilities relating to that activity. The term ‘joint venture’ therefore refers to a jointly controlled activity in which the parties have an investment.

It is possible that the parties may undertake different activities within a single vehicle and have different rights to the assets and obligations for the liabilities relating to these different activities. However, the IASB believes that even though this situation is conceptually possible, it would be rare in practice.

In addition, the parties may be bound by a framework agreement that sets up the general contractual terms for undertaking one or more activities, which sets out that the parties establish different joint arrangements for specific activities that form part of the agreement. Even though those joint arrangements are governed under the same framework agreement, the type of each arrangement may
differ if the parties’ rights and obligations differ. Therefore, joint operations and joint ventures can co-exist when the parties undertake different activities that form part of the same framework agreement.

**Example – Joint arrangements under a framework agreement**

Illustrative example 3 in IFRS 11 addresses an arrangement in which two parties have set up a strategic and operating agreement (the framework agreement) in which they have agreed the terms under which they will conduct the manufacturing and distribution of product P in different markets. The parties have agreed to establish separate manufacturing and distribution joint arrangements to conduct the respective activities.

The joint arrangements are structured through separate vehicles. Under the framework agreement, the parties commit to purchasing all of the production from the manufacturing arrangement in accordance with their respective ownership interests. They subsequently sell the finished output to the distribution arrangement. The distribution arrangement orders its requirements for the product from the parties according to the needs of the different markets in which the product is sold. In turn, the manufacturing arrangement produces the product to meet this demand.

Each joint arrangement is analysed individually and separately to determine its type, even though the joint arrangements are governed by a single framework agreement. This could result in one arrangement being classified as a joint venture and the other being classified as a joint operation.

**Insight – What is the unit of account?**

Many respondents to the 2005 exposure draft had been concerned that joint ventures could be merely ‘residuals’. The IASB notes that this is because those respondents had interpreted ‘joint venture’ to mean that after the parties had identified rights to individual assets and obligations for expenses or financing, joint ventures would be merely any remaining assets and liabilities of the arrangement. As a result of this concern, the IASB clarified that the unit of account is the activity.

Although the term ‘activity’ is not defined, this does make clear that the whole of an activity is classified as either a joint operation or a joint venture. That is, it seems that one part of an activity cannot be subject to joint venture accounting and another to joint operation accounting; rather, it must be wholly one or the other.

There is some tension between the unit of account stated by the IASB as the activity and the application of the unit of account in illustrative example 3 included in IFRS 11, and possibly, in practical application.

Illustrative example 3, as described above, shows the analysis performed in respect of two activities, when each is structured through a separate vehicle. However, the IASB also introduces a variation to that example (see example in 4.5), so that both activities are included in a single vehicle. Based on IFRS 11’s stated unit of account, it might be expected that the analysis would address each activity separately. However, the example’s solution includes a single analysis, which might imply that the unit of account is the vehicle rather than the activity. In other words, this seems to imply that when the arrangement is structured through a single vehicle, the unit of account generally could not be at a lower level than the vehicle. However, as previously discussed in 3.2, some consideration may also need to be given to silos.

A similar tension could also arise when a single activity is structured through more than one vehicle. It seems inherently difficult to apply the tests at a higher level than a single vehicle.
To sum up at this stage:

- The unit of account is the activity, which is undefined and throws up some tension with the vehicle level.
- More than one jointly controlled activity may exist under a framework agreement, presumably each in a separate vehicle.
- The unit of account is classified, in its entirety, either as a joint operation or as a joint venture, as the case may be.

The important question that then arises is this: is joint operation classification based on having rights and obligations for all of the assets and liabilities of the unit of account or for some measure of the assets and liabilities falling short of all of them? Although the standard is not explicit on this point, at this early stage of its practical application it appears that the better view is that a joint operator is indeed required to have rights and obligations in relation to all (or, perhaps, substantially all) of the joint arrangement’s assets and liabilities.

For example, if some lesser measure than ‘all’ were the intended test, then the standard gives no clue as to what that lesser measure would be. Furthermore, to account directly for those of the assets and liabilities for which the joint controller does not have direct rights and obligations would seem to run counter to the main current of the standard, i.e. that parties account for their rights and obligations arising from the joint arrangement. It also seems that paragraph BC35 of IFRS 11 contemplates the possibility that there are rights and obligations for some but not all assets and liabilities, and it seems to indicate that joint venture classification is appropriate.

### 4.2 Structure of joint arrangements

**IFRS 11A, B16**
A joint arrangement not structured through a separate vehicle can be classified only as a joint operation. A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

**IFRS 11B19**
A joint arrangement structured through a separate vehicle can be either a joint venture or a joint operation. That is, a separate vehicle is a necessary but not a sufficient condition for a joint venture. If there is a separate vehicle, then the remaining tests are applied.

**Main change from IAS 31**

Although one of the changes that IFRS 11 introduces is that the structure of an arrangement is no longer the main factor in determining the accounting, it appears that in most cases it is a substantial factor. The absence of such a vehicle is decisive in determining the parties’ rights and obligations arising from the arrangements, i.e. it is a joint operation.

When the arrangement is structured through a separate vehicle, the structure itself is not determinative. However, it is still a significant factor, as we expect that in practice other considerations will not often lead to classification as a joint operation. This is because, as discussed in 4.3 to 4.5, the contractual arrangement is normally consistent with the separate vehicle’s legal form. Also, other facts and circumstances that cause joint operation classification may be less common in certain industries/jurisdictions than in others.
As jointly controlled assets and jointly controlled operations under IAS 31 are not structured through a separate vehicle, they will be classified as joint operations under IFRS 11. The accounting for those arrangements is broadly the same as under IAS 31, i.e. an entity accounts for its interest in the underlying assets and liabilities (see 5.2).

4.3 The legal form of the arrangement

IFRS 11.B22, B24

If the legal form of the separate vehicle does not confer separation between the parties and the separate vehicle, i.e. the assets and liabilities placed in the separate vehicle are the parties’ assets and liabilities, then the joint arrangement is a joint operation.

Example – Assessing the legal form

Illustrative example 1 in IFRS 11 shows a joint arrangement for construction services:

- The two parties set up a separate entity, whereby the main feature of its legal form is that the parties (and not the entity) have rights to the assets and obligations for the liabilities of the entity.
- The contractual arrangement between the parties establishes the parties’ rights to the assets, responsibility for all operational or financial obligations and the sharing of profit or loss.

As the arrangement is structured through a separate entity, the parties consider the legal form of the separate vehicle. In this example, because the legal form of the separate vehicle does not confer separation between the parties and the vehicle, the joint arrangement is a joint operation.

The following should be noted:

- As the legal form of the separate vehicle is sufficient to conclude that the joint arrangement is a joint operation, there is no requirement to consider the terms of the contractual arrangement, though they are consistent with the legal form of the arrangement in this illustrative example, or other facts and circumstances.
- The fact that the parties have agreed to share the profit or loss arising from the arrangement would not prevent the arrangement from being a joint operation as the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.

Main change from IAS 31

Under IAS 31 all partnerships were classified as jointly controlled entities based on their structure as separate vehicles, and therefore were afforded a choice of using either the equity method or proportionate consolidation. However, in some jurisdictions partnerships confer no separation between the parties and the vehicle itself. Such arrangements are classified as joint operations under IFRS 11 and therefore the parties account for the underlying assets and liabilities of the arrangement. This accounting is similar in effect to proportionate consolidation, but it occurs in the separate financial statements as well as in the consolidated financial statements (see 5.2). For entities that previously accounted for their interest in such partnerships using the equity method, this change can affect every line item of the financial statements.
Other than certain partnerships, we expect that most separate vehicles will confer legal separation between the parties and the vehicle. Therefore, in the absence of other relevant contractual arrangements or other facts and circumstances, the joint arrangement will be a joint venture.

**Insight – Unlimited liability vehicles**

If a vehicle has no separate legal personality, so that the rights to its assets and obligations for its liabilities are those of the parties and it is a joint operation, then the parties may also be said to have unlimited liability in relation to the arrangement. However, unlimited liability is not exclusive to cases in which the liabilities are those of the parties rather than of the vehicle. It is possible for a vehicle to have a separate legal personality and for the parties to have unlimited liability, e.g. unlimited companies in some jurisdictions. In this latter case the unlimited nature of the parties’ liability will not cause it to be a joint operation.

The reason is that an unlimited liability vehicle of that kind usually provides the parties with a secondary obligation for all of the vehicle’s liabilities rather than a primary obligation for each of the vehicle’s liabilities. (Similarly, in those cases it is often the vehicle that has rights to the assets rather than the parties to the arrangement.) When the liabilities are those of the vehicle, the unlimited nature of the parties’ liability is essentially a guarantee of all of the vehicle’s liabilities or is an open-ended obligation for uncalled capital, which, as addressed under the contractual arrangements test (see 4.4), IFRS 11 does not consider to be a direct and primary obligation for the vehicle’s liabilities. Nor would unlimited liability necessarily be a fact and circumstance causing joint operation classification. Finally, as noted in 4.1.1, rights to assets are also required for joint operation classification.

### 4.4 The contractual arrangement

**IFRS 11.B28**

When the contractual arrangement specifies that the parties have:

- rights to the assets; and
- obligations for the liabilities

relating to the arrangement, then the arrangement is a joint operation.

**IFRS 11.B27**

A guarantee to third parties provided by the parties to the arrangement, e.g. for service provided by or financing provided to the arrangement, does not in itself determine that the joint arrangement is a joint operation, as it does not provide the parties with rights to assets and obligations for liabilities.

**IFRS 11.B27**

An obligation for unpaid or additional capital also does not result in joint operation classification.

**Example – Assessing the contractual arrangement**

**IFRS 11.E34-E43**

Illustrative example 5 in IFRS 11 shows a separate vehicle, entity H, undertaking oil and gas exploration, development and production activity. The main feature of H’s legal form is that the assets and liabilities of the separate vehicle are considered to be its own and not those of the parties.

The two parties also establish a shareholders’ agreement and a joint operating agreement to establish their rights and obligations relating to those activities.
The joint operating agreement specifies that the rights and obligations arising from H’s activities are shared among the parties in proportion to each party’s holdings, and in particular that the parties share the rights and obligations arising from the exploration and development permits granted to H, the production obtained and all related costs.

Costs incurred in relation to all work programmes are covered by cash calls on the parties. In the event that one party fails to meet its monetary obligations, the other party is required to contribute to H the amount in default; that amount will be considered debt owed by the defaulting party to the other party.

As the arrangement is structured through a separate vehicle, the parties first consider the legal form of the separate vehicle. In this case the legal form confers separation between the parties and the separate vehicle, resulting in an initial indication that the arrangement is a joint venture. However, as the contractual arrangement explicitly provides the parties with rights to the assets and obligations for the liabilities, that initial indication is reversed and the joint arrangement is a joint operation.

**Example – The effect of guarantees**

Illustrative example 6 in IFRS 11 shows a separate vehicle, entity C, that develops and operates a gas field and a liquefied natural gas facility. The main feature of C’s legal form is that the assets and liabilities of the separate vehicle are considered to be its own and not those of the parties. The contractual arrangement does not specify that the parties have rights to the assets and obligations for the liabilities of C.

C enters into a financing arrangement with a syndicate of lenders to help fund the development of the field and facility. The loan will fund 70 percent of the expected development cost, which is equivalent to 54 percent of the enterprise value*. The syndicate has recourse to the parties only if C defaults on the loan arrangement during the development of the field and construction of the facility; the guarantee expires when production starts. The syndicate maintains protection against default by C by taking a lien on the facility.

As the arrangement is conducted through a separate vehicle whose legal form confers separation between the parties and the separate vehicle, this is an initial indication that the arrangement is a joint venture. The contractual arrangement does not specify that the parties have rights to the assets and obligations for the liabilities. There are no other facts and circumstances to consider. Accordingly, the joint arrangement is a joint venture.

The recourse nature of the financing arrangement does not, in itself, impose on the parties an obligation for the liabilities of C, but rather it is a separate obligation, i.e. a guarantee to repay the loan in the event of a default during a specified stage of the activity.

**Insight – Primary not secondary obligation**

The above examples provide some insight as to the meaning of ‘obligations for the liabilities’.

Based on the guarantee and uncalled capital cases, it seems that the contractual obligation for liabilities is something that needs to reflect a primary obligation, rather than a secondary one; and something that represents a non-contingent, ongoing obligation, rather than an obligation that will be settled if and when a certain event occurs.

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* The developed enterprise value is 70 percent debt funded + 30 percent cash funded (original cash injection in equity) + 30 percent field value (original non-monetary contribution, assumed equal value to cash injection) = 130 percent of the development cost. The debt is therefore 54 percent of the enterprise value (70 percent ÷ 130 percent).
This seems to mean that, so far as the contractual arrangement step of the analysis is concerned, the parties can have a significant level of exposure, but the joint arrangement is still classified as a joint venture. For example, in IFRS 11’s illustrative example 6, the parties guarantee debt amounting to 54 percent of the arrangement’s enterprise value and yet it remains (at this step) a possible joint venture.

**Insight – Guarantees in particular**

It is fortunate that the IASB has not decided that a guarantee of an arrangement’s debt would necessarily trigger classification as a joint operation. This is important as many lenders to joint arrangements will require the parties to guarantee the debt of the joint arrangement. If that fact alone precluded joint venture classification, then there would be few arrangements that would be classified as joint ventures.

In 4.1.1, we discussed an example in which an arrangement consists of a company that holds and develops a property and has a bank loan financing that development, guaranteed by the parties. As with the illustrative examples included in IFRS 11, this guarantee does not, in itself, determine that the parties have obligations for the liabilities of the separate vehicle. The bank’s claim on the parties arises only on default.

**Insight – Similar to piercing the corporate veil?**

Returning to our observation that the contractual terms appear, for joint operation classification, to need to give direct, primary obligations for the liabilities and direct rights to the assets, it seems as though the contract must do something similar to piercing the corporative veil of the separate vehicle. That is to say, although there is a vehicle with separate legal personality, the contractual arrangement needs to give the parties direct legal rights to that vehicle’s assets and direct, primary obligations for its liabilities. That might be quite difficult to achieve in many jurisdictions, and therefore we expect that relatively few arrangements conducted through a separate vehicle will become joint operations as a result of the contractual terms test.

Finally, the examples cited by IFRS 11 do not specify whether the vehicle is also a party to the contract that gives the parties rights to its assets and obligations for its liabilities. We note also that for this step in the analysis to be relevant, the vehicle would have a legal form that is separate from the parties. Therefore, *prima facie*, we would expect that the vehicle is required to be party to a contract that aims at giving others rights and obligations in relation to its assets and liabilities. However, it may be quite difficult to construct such contracts.
4.5 Other facts and circumstances

The test at this step of the analysis is to identify whether, in spite of the legal form and contractual arrangement indicating that the arrangement is a joint venture, other facts and circumstances:

- give the parties rights to substantially all of the economic benefits relating to the arrangement; and
- cause the arrangement to depend on the parties on a continuous basis for settling its liabilities and therefore the arrangement is a joint operation.

When the activities of an arrangement are designed to provide output to the parties and the arrangement is limited in its ability to sell to third parties, this indicates that the parties have rights to substantially all the economic benefits of the arrangement’s assets. Such an arrangement also has the effect that the liabilities incurred by the arrangement are, in substance, satisfied only by the cash flows received from the parties through their purchase of the output. When the parties are substantially the only source of cash flows contributing to the arrangement’s operations, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

Insight – Different words used in different places in IFRS 11

This step of the analysis is the most difficult one and its test and the illustrations of its application are unhelpfully articulated in different words at different places in IFRS 11, including:

- “When the activities of a joint arrangement are primarily designed for the provision of output to the parties, this indicates that the parties have rights to substantially all of the economic benefits of the assets of the arrangement.”
- “The parties designed the arrangement so that (a) its activities primarily aim to provide the parties with an output (ie the parties have rights to substantially all of the economic benefits of the assets held in the separate vehicle)…”
- Reference to “substantially all the economic benefits” is also the wording used throughout IFRS 11’s examples.

At this early stage of practical application it appears that the best view as to a single statement of the test, taking all of the above into account, is as follows: do the parties have rights to substantially all of the economic benefits of the assets relating to the arrangement; and does the arrangement depend on the parties on a continuous basis for settling its liabilities?

This is the wording that we have used in our flowchart in 4.1 and to state the test at the beginning of 4.5, and is consistent with the wording used in paragraphs B31 and B32 of IFRS 11.

It is not clear whether the output off-take case cited above is intended to be the only scenario that would lead to a joint arrangement being classified as a joint operation based on facts and circumstances, or whether there are other scenarios that may also result in classification of the arrangement as a joint operation.
Insight – Comparison with the contractual arrangement test

The contractual arrangement test asks whether the contract gives the parties rights to the assets and obligations for the liabilities. The facts and circumstances test differs from that. On the assets side it looks for rights to substantially all of the economic benefits of the assets, rather than to ownership of or legal rights to the assets themselves. For the liabilities, it looks at whether the liabilities depend on the parties on a continuous basis (what might be termed an ‘in-substance’ obligation), rather than an actual legal obligation.

The contractual terms may, however, be facts and circumstances to be considered in this step. Even though contractual terms do not specify that the parties have legal rights to the assets, they may give rights to their economic benefits; and even though they do not explicitly impose legal obligations, they may give in-substance obligations.

Insight – Classification based on facts and circumstances

The output off-take case cited above is a common one in certain industries/jurisdictions. Whether there can be other cases that qualify as a joint operation as a result of facts and circumstances, and whether such cases would be more than rarities, remains to be seen.

Example – Assessing facts and circumstances

Illustrative example 3 in IFRS 11 is also discussed in 4.1. In this example, two parties have set up a strategic and operating agreement (the framework agreement) in which they have agreed the terms under which they will conduct the manufacturing and distribution of product P in different markets. Continuing the example, the parties have agreed the following in respect of the manufacturing arrangement:

- the manufacturing arrangement will produce product P to meet the demand required by the parties;
- the parties have committed themselves to purchasing its whole production in accordance with their ownership interests at a price that covers all production costs incurred; and
- any cash shortages are financed by the parties in accordance with their ownership interest.

The parties have agreed the following in respect of the distribution arrangement:

- the parties will sell the finished output, purchased from the manufacturing arrangement, to the distribution arrangement at a price to be fixed by the parties; and
- the distribution arrangement will subsequently sell the output to the market.

As the arrangements are structured through separate vehicles, whose legal form confers separation between the parties and the separate vehicles, there is an initial indication that the arrangements are joint ventures.

The contractual arrangements do not amend or change the rights and obligations of the parties and therefore do not reverse the initial indication that the joint arrangements are joint ventures.
However, in respect of the manufacturing arrangement, the other facts and circumstances lead to the conclusion that the arrangement is a joint operation since:

- the parties have committed themselves to purchasing all of the production manufactured and therefore have rights to substantially all the economic benefits of the assets; and
- the parties have an obligation for the manufacturing arrangement’s liabilities, as there is exclusive dependence on the parties for the generation of cash flows and to cover any cash shortages.

In respect of the distribution arrangement, there are no other facts and circumstances that would indicate that the arrangement is a joint operation. The distribution arrangement is therefore considered a joint venture.

**Changing the example**

Changing the above fact pattern, assume that the manufacturing vehicle also distributes the products itself to third-party customers and in relation to specific markets, directly to the distribution vehicle. However, no fixed proportion of the production is committed to be purchased by, or reserved for, the distribution vehicle. There is no purchase or sale of the product by the parties.

In this modified example, the manufacturing vehicle becomes a self-financed arrangement that has a trade of its own, distributing product P to third-party customers, and consequently assuming demand, inventory and credit risks. The manufacturing arrangement is not dependent on the parties to be able to carry out its activities on a continuous basis. In this modified example, the manufacturing vehicle is determined to be a joint venture. There is no change in conclusion that the distribution vehicle is a joint venture.

**Insight – Direct access to the market**

In the above modification of illustrative example 3 in IFRS 11 (‘Changing the example’), it is the consideration of additional facts and circumstances, including the access to market, that leads to joint venture classification. Therefore, it appears that a vehicle’s direct access to market (and therefore its exposure to demand, inventory and credit risks) on its own, might not be sufficient to classify an arrangement as a joint operation.

**Insight – What is the unit of account?**

In addition to highlighting an issue of classification, illustrative example 3 in IFRS 11 also points back to the analysis of the unit of account of a joint arrangement. As noted in 4.1.2, the unit of account is the activity, which is undefined. It appears from the original example that manufacturing and distribution could be different activities, at least when carried on in different vehicles. In the variation to the example, when the manufacturing and some of the distribution are carried on in a single vehicle, the IASB seems to regard that vehicle as conducting only one activity or otherwise as a single unit of account, i.e. it does not analyse that vehicle’s manufacturing and distribution as different activities/units of account.
5. Financial statements of joint controllers

The following table is a simplified overview of the general accounting requirements for parties that share joint control over the arrangement. Sections 5.1 and 5.2 provide fuller details and exceptions.

<table>
<thead>
<tr>
<th></th>
<th>Consolidated financial statements</th>
<th>Separate financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint venturers</td>
<td>Equity method in accordance with IAS 28 (2011).</td>
<td>Choice between cost or in accordance with IFRS 9/IAS 39.</td>
</tr>
<tr>
<td>Joint operators</td>
<td>Recognises its own assets, liabilities and transactions, including its share of those incurred jointly.</td>
<td></td>
</tr>
</tbody>
</table>

5.1 Joint venturers

5.1.1 Consolidated financial statements

IFRS 11.24 In its consolidated financial statements, a joint venturer accounts for its interest in the joint venture using the equity method in accordance with IAS 28 (2011) Investments in Associates and Joint Ventures, unless, under IAS 28 (2011), the entity is exempted from applying the equity method.

IAS 28.18 Under IAS 28 (2011), a joint venturer may elect to measure its investment in a joint venture at fair value through profit or loss in accordance with IFRS 9 Financial Instruments/IAS 39 Financial Instruments: Recognition and Measurement when the investment is held directly or indirectly through a venture capital organisation, or certain similar entities (see 7.5).

IFRS 10.4(a), IAS 28.17 A joint venturer is not required to prepare consolidated financial statements or otherwise apply the equity method if it is a parent that is exempt from preparing consolidated financial statements in accordance with IFRS 10, or it is an intermediate entity meeting certain requirements; then it may elect not to prepare consolidated financial statements and therefore not to equity account. The requirements are: it is unlisted and not in the process of listing; its owners do not object; and a higher parent produces IFRS consolidated financial statements that are available for public use.

IAS 28.3 Under the equity method, the investment in a joint venture is recognised initially at cost, and subsequently adjusted for the post-acquisition changes in the share of the joint venture’s net assets. The joint venturer’s share of profit or loss and other comprehensive income of the joint venture is included in its profit or loss and other comprehensive income, respectively.

Insight – Venture capital organisations

Although the exception for venture capital organisations, or certain similar entities, has been maintained (see 7.5), in our experience it is not common for such entities to be parties to joint arrangements in which they have joint control, i.e. joint controllers.

Main change from IAS 31

IAS 31 included a choice of accounting for a joint controller’s interest in a jointly controlled entity using either the equity method or proportionate consolidation. IFRS 11 does not provide a similar choice for joint ventures, and eliminates the alternative of proportionate consolidation.
Generally, we expect that many jointly controlled entities under IAS 31 will become joint ventures under IFRS 11. For those arrangements that under IAS 31 have been accounted for using proportionate consolidation, the result of applying the equity method can affect all of the financial statement line items of such an entity. This change is expected to be widespread as, in our experience, currently approximately half of the entities applying IFRSs use proportionate consolidation while the other half use the equity method to account for jointly controlled entities.

The following table summarises the potential effects, assuming a typical format for the statement of financial position and statement of comprehensive income, with the share of joint ventures included outside the results from operations:

<table>
<thead>
<tr>
<th>Financial statements</th>
<th>Potential effects</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Statement of financial position</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-current assets</td>
<td>Increase or decrease</td>
<td>Depends on whether the joint venture’s net assets exceed its non-current assets or <em>vice versa.</em></td>
</tr>
<tr>
<td>Current assets</td>
<td>Decrease</td>
<td>The joint venture’s assets will no longer be proportionately consolidated.</td>
</tr>
<tr>
<td>Equity</td>
<td>Potential increase if the venture has net liabilities</td>
<td>Under the equity method, a share of net liabilities is not recognised (the investment is reduced to nil and no further) unless certain conditions are met.</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td>Decrease</td>
<td>The joint venture’s liabilities will no longer be proportionately consolidated.</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>Decrease</td>
<td>The joint venture’s liabilities will no longer be proportionately consolidated.</td>
</tr>
<tr>
<td><strong>Statement of comprehensive income</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>Decrease</td>
<td>The joint venture’s revenues will no longer be proportionately consolidated.</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>Decrease</td>
<td>The joint venture’s operating expenses will no longer be proportionately consolidated.</td>
</tr>
<tr>
<td>Results from operating activities</td>
<td>Increase or decrease</td>
<td>Depends on the results of the joint venture.</td>
</tr>
<tr>
<td>Operating margin (results from operating activities divided by revenue)</td>
<td>Increase or decrease</td>
<td>Depends on the profitability of the joint venture relative to the group.</td>
</tr>
<tr>
<td>Net finance costs</td>
<td>Increase or decrease</td>
<td>The joint venture’s net finance costs will no longer be proportionately consolidated; the increase or decrease depends on the net finance costs of the joint venture.</td>
</tr>
<tr>
<td>Share of profit of equity-accounted investees</td>
<td>Increase or decrease</td>
<td>Depends on the results of the joint venture.</td>
</tr>
<tr>
<td>Profit or loss before tax</td>
<td>Increase or decrease</td>
<td>Decrease if the joint venture has a tax expense as this is now taken up in the venturer’s pre-tax results, and <em>vice versa.</em></td>
</tr>
<tr>
<td>Profit or loss</td>
<td>Potential increase when the venture has net liabilities</td>
<td>See explanation in relation to equity.</td>
</tr>
</tbody>
</table>
Insight – Other effects of ceasing proportionate consolidation

As well as the above major presentational change, there may also be other consequential accounting effects of ceasing proportionate consolidation. For example, when a venturer has hedged a joint venture’s asset or liability (e.g. hedge of interest rate risk on the joint venture’s debt), there is no case for hedge accounting once equity accounting is applied. Similarly, a venturer’s interest expense may no longer be capitalised into a joint venture’s asset.

These changes may have a significant effect on financial ratios and/or debt covenants as determined using the consolidated financial statements. These changes also may affect any management or employee compensation based on the consolidated financial statements.

5.1.2 Separate financial statements

(IFRS 11.26(b), IAS 27.10)

In its separate financial statements, a joint venturer accounts for its interest in the joint venture in accordance with IAS 27 (2011) Separate Financial Statements, i.e. either at cost or in accordance with IFRS 9/IAS 39. This choice is available even if the entity is not required to prepare consolidated financial statements, or financial statements in which the equity method is used (see 5.1.1).

However, if the interest in the joint venture is being held through a venture capital organisation, or certain similar entities, and is accounted for in accordance with IFRS 9/IAS 39 in the consolidated financial statements (see 7.5), then the same accounting is used in the separate financial statements.

Main change from IAS 31

The existing requirements of IAS 27 (2008) are carried forward; therefore, no significant effect is expected from the perspective of the separate financial statements.

5.2 Joint operators

5.2.1 Consolidated and separate financial statements

(IFRS 11.20, 21, 26(a), IFRS 11.B17, B18)

In both its consolidated and separate financial statements, a joint operator recognises its assets, liabilities and transactions, including its share of those incurred jointly. These assets, liabilities and transactions are accounted for in accordance with the relevant IFRSs.

Two examples are given in which the parties to a joint operation may recognise their rights to the assets and revenues and obligations for the liabilities and expenses, based on their rights and obligations:

- The arrangement establishes *shared rights to assets and revenues, and shared obligations for the liabilities and expenses*. For example, the parties share and operate assets together. In this example, the agreement establishes the rights to the assets that are operated jointly and how output or revenues from the assets and operating costs are shared among the parties. In such arrangements, each party accounts for its share of assets, liabilities, output or revenues and expenses in accordance with the terms of the arrangement.

- The arrangement establishes *unshared rights to the assets, unshared obligations for the liabilities and shared rights to revenues and obligations for the expenses*. For example, the parties agree to manufacture a product together, but each party is responsible for a specific task using its own assets and incurring its own liabilities. The arrangement also specifies how the common revenues and expenses will be shared among the parties. In its financial statements, each
party recognises its assets and liabilities used for the specific task, and revenues and expenses in accordance with the terms of the arrangement.

5.2.2 Upstream and downstream transactions

IFRS 11.22, B34, B35 When a joint operator sells or contributes assets to a joint operation, such transactions are in effect transactions with other parties to the joint operation. The joint operator recognises gains and losses from such transactions only to the extent of the other parties’ interests in the joint operation. The full amount of any loss is recognised immediately by the joint operator, to the extent that these transactions provide evidence of impairment of any assets to be sold or contributed.

IFRS 11.22, B36, B37 When a joint operator purchases assets from a joint operation, it does not recognise its share of the gains or losses until those assets have been sold to a third party. The joint operator’s share of any losses is recognised immediately, to the extent that these transactions provide evidence of impairment of those assets.

Insight – Accounting for upstream and downstream transactions

IFRS 11.BC46 In setting the above requirement for transactions between a joint operator and its joint operation, the IASB notes that it did not aim to change the ultimate accounting.

Although the outcome may not be different, the logic by which it is arrived at may be. For example, the requirements for downstream transactions seem more in keeping with the main thrust of the standard on joint operations. That is, the respective parts of the joint operation are not separate from its joint operators. There is therefore no sense of a gross sale to a separate investee with elimination of a portion of the gain; rather the only sale is of a partial interest in the asset to the other joint operator. However, the requirements for upstream transactions seem more reminiscent of the ‘gross and eliminate’ methodology. It remains to be seen whether this lack of clarity has any practical consequences.
6. Financial statements of other parties to a joint arrangement

IFRS 11 is applied by all entities that are a party to a joint arrangement.

The following table is a simplified overview of the general accounting requirements for parties that participate in, but do not have joint control over, the arrangement (other parties). Sections 6.1 and 6.2 provide fuller details and exceptions.

<table>
<thead>
<tr>
<th></th>
<th>Consolidated financial statements</th>
<th>Separate financial statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other parties to a joint venture</td>
<td>If significant influence exists, then equity method in accordance with IAS 28 (2011); otherwise, in accordance with IFRS 9/IAS 39.</td>
<td>If significant influence exists, then choice between cost or in accordance with IFRS 9/IAS 39; otherwise, in accordance with IFRS 9/IAS 39.</td>
</tr>
<tr>
<td>Other parties to a joint operation</td>
<td>Recognises its own assets, liabilities and transactions, including its share of those incurred jointly, it if has rights to the assets and obligations for the liabilities.</td>
<td>Otherwise, it accounts for its interest in accordance with the IFRS applicable to that interest, e.g. IAS 28 (2011) or IFRS 9/IAS 39, as the case may be.</td>
</tr>
</tbody>
</table>

Insight – Determining the type of joint arrangement

Under IFRS 11, other parties to a joint arrangement need to know what type of joint arrangement it is for the joint controllers. This determines their accounting.

Following IFRS 11’s approach may appear to be difficult when that party has limited information on the terms of the contractual arrangement and other facts and circumstances relating to the joint controllers. However, from a practical perspective, the only scenario in which an issue may arise is if the other party has rights to, and obligations for, the underlying assets and liabilities in a joint venture. (In other cases, the accounting just follows the nature of the party’s involvement, whether it is in a joint operation or joint venture.) We expect that such scenarios would be unlikely in practice, as the other party would have more direct rights to, and obligations for, the underlying assets and liabilities than the joint controllers themselves.

6.1 Other parties to a joint venture

6.1.1 Consolidated financial statements

In its consolidated financial statements, other parties account for their interests in the joint venture in accordance with IFRS 9/IAS 39, or IAS 28 (2011) if significant influence exists.

If significant influence exists, then the entity may elect to measure its investment in the joint venture at fair value through profit or loss in accordance with IFRS 9/IAS 39 when the investment is held directly or indirectly through a venture capital organisation, or certain similar entities (see 75). Otherwise, it applies the equity method, assuming that the entity is not required to prepare consolidated financial statements, or financial statements in which the equity method is used (see 5.1.1).
Under both IFRS 9 and IAS 39, the interest in a joint venture is measured initially at fair value. The accounting subsequent to initial recognition depends on the classification of the asset (under IAS 39) or the election with respect to presenting gains or losses in other comprehensive income (under IFRS 9).

**Main change from IAS 31**

The existing requirements of IAS 31 are carried forward in respect of investors in a joint venture that do not have joint control, i.e. other parties in IFRS 11. Therefore, if jointly controlled entities under IAS 31 are classified as joint ventures under IFRS 11, then we do not expect a change in the accounting by such parties.

### 6.1.2 Separate financial statements

In their separate financial statements, other parties to a joint venture account for their interest in the joint venture in accordance with IFRS 9/IAS 39. If significant influence exists, then the interest may also be accounted for at cost. This choice is available even if the entity is not required to prepare consolidated financial statements, or financial statements in which the equity method is used (see 5.1.1).

However, if the interest in the joint venture is accounted for in accordance with IFRS 9/IAS 39 in the consolidated financial statements, then the same accounting is adopted for the separate financial statements.

### 6.2 Other parties to a joint operation

#### 6.2.1 Consolidated and separate financial statements

Another party to a joint operation accounts for its investment in the same way as a joint operator if it has rights to the assets and obligations for the liabilities. If such a party does not have such rights and obligations, then it accounts for its interest in accordance with the IFRS applicable to that interest, e.g. IAS 28 (2011) or IFRS 9/IAS 39, as the case may be.

**Main change from IAS 31**

Under IAS 31, an investor in a jointly controlled asset/operation accounted for its investment in accordance with IFRS 9/IAS 39, unless significant influence existed, in which case the investment was accounted for in accordance with IAS 28 (2008). This created something of a tension with IFRS 9/IAS 39 jointly controlled assets/operations did not involve a separate vehicle, but direct interests in operating assets. How then could a single financial asset, representing the whole interest, arise without holding an equity instrument in an entity?

This particular tension is resolved by IFRS 11. If a party to a joint operation that does not have joint control has rights to the assets and obligations for the liabilities, then it accounts for the underlying assets, liabilities and transactions of the joint operation.
7. Significant amendments to IAS 28 (2011)

IAS 28 was revised in 2011 in connection with the IASB’s project on joint arrangements. The majority of these revisions result from the incorporation of joint ventures into IAS 28 (2011); the fundamental approach to accounting for equity-accounted investments has not been changed.

This section highlights the significant amendments to IAS 28 (2011).

7.1 Potential voting rights or other derivatives

The investor’s or joint venturer’s share taken up in applying the equity method does not reflect any possible exercise or conversion of potential voting rights and other derivatives containing potential voting rights, except when such instruments give current access to the returns associated with an ownership interest. In such scenarios, the share allocated to the entity is calculated taking into account the eventual exercise of such instruments.

Instruments containing potential voting rights that in substance give current access to the returns associated with an ownership interest in an associate or a joint venture are not subject to IFRS 9/IAS 39. IFRS 9/IAS 39 applies to all other financial instruments containing potential voting rights.

Main change from IAS 28 (2008)

The concept of applying the equity method in respect of in-substance ownership interests is carried forward from IAS 28 (2008) and IAS 27 (2008). The phrase “in substance, give access to the returns associated with an ownership interest” replaces “in substance, gives access at present to the economic benefits associated with an ownership interest.” Most of these wording changes are clearly cosmetic. However, given the wider meaning potentially attached to ‘returns’ in IFRS 10, there may be a question on the replacement of ‘economic benefit’ with ‘returns’. See our publication First Impressions: Consolidated financial statements for further discussion on returns in the context of IFRS 10.

The existence and the effect of potential voting rights that are currently exercisable or convertible, including potential voting rights of other entities, are considered when assessing whether an entity has significant influence, regardless of, for example, the financial ability to exercise.

Although the IASB considered whether the requirements in respect of potential voting rights should be changed to be consistent with IFRS 10, any changes will be made as part as a wider review of significant influence.

Insight – Conflict between IFRS 10 and IAS 28 (2011)

The requirement to consider potential voting rights when assessing whether significant influence exists is carried forward from IAS 28 (2008). However, the parallel requirement in IAS 27 (2008) was modified by IFRS 10 in respect of consideration of potential voting rights when assessing control. See our publication First Impressions: Consolidated financial statements for further discussion on potential voting rights in the context of IFRS 10. Therefore, the effect of potential voting rights can be different when assessing significant influence and when assessing control – a case of IASB-made divergence. Note, however, that IFRS 10’s approach to potential voting rights does apply when assessing joint control (see 3.3).
Held-for-sale classification

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations applies to an investment, or to a portion of an investment, in an associate or a joint venture that meets the criteria to be classified as held for sale. For any retained portion of the investment that has not been classified as held for sale, the entity applies the equity method until disposal of the portion classified as held for sale. After disposal, any retained interest in the investment is accounted for in accordance with IFRS 9/IAS 39 or by using the equity method if the retained interest continues to be an associate or a joint venture.

Main change from IAS 28 (2008)

More specific provision is included in IAS 28 (2011) with respect to the application of IFRS 5 to investments in associates or joint ventures.

Insight – What is the unit of account?

Under IFRS 5, the unit of account is a whole non-current asset or a whole disposal group, which, if classified as held for sale, is stated at the lower of its carrying amount and fair value less cost to sell. Held-for-sale is stated in IFRS 5 in terms of recovery principally through sale of that unit of account, although it is also associated with a change in status, i.e. loss of control. This new provision of IAS 28 (2011), however, is stated in terms not of the whole investment but of the portion to be sold.

Changes in interests held

If an investment in an associate becomes an investment in a joint venture, or vice versa, then the equity method continues to be applied and the entity does not remeasure the retained interest.

If there is a loss of joint control but significant influence is retained (i.e. a joint venture becomes an associate), then there is a change in the investor-investee relationship and consequently a change in the nature of the investment. However, both investments continue to be measured using the equity method. As there is neither a change in the group boundary nor a change in the measurement requirements, such a change in the status of the investment is not considered to be an event that warrants remeasurement of the retained interest.

IFRS 11.D34, BCA5, IAS 21.48-48D, 28.25

If an entity’s ownership interest in an associate or joint venture is reduced but the equity method continues to be applied, then an entity reclassifies to profit or loss any equity-accounted gain or loss previously recognised in other comprehensive income in proportion to the reduction in the ownership interest. However, such reclassification applies only if that gain or loss would be required to be reclassified to profit or loss on disposal of the related asset or liability. Cumulative translation adjustments on foreign operations are an example of such a gain or loss that is now proportionately reclassified in such circumstances, and IAS 21 The Effects of Changes in Foreign Exchange Rates has been amended accordingly.

Main change from IAS 28 (2008) and IAS 31

Previously, IAS 28 (2008) and IAS 31 specified that the cessation of significant influence or joint control triggered remeasurement of any retained stake, even if significant influence was succeeded by joint control, or vice versa. IAS 28 (2011) now requires that in such scenarios the retained interest is not remeasured.
See appendix 1 for a table illustrating all possible changes in the status of investments in associates and joint ventures.

Existing guidance is carried forward from IAS 28 (2008) in respect of the reclassification to profit or loss of gains/losses previously recognised in other comprehensive income on reduction of the ownership interest of an associate or joint venture while it still remains an associate or joint venture. However, it is now beyond doubt that only gains/losses that would have been reclassified to profit or loss on disposal of the related assets/liabilities are subject to this requirement.

7.4 Contribution of a non-monetary asset

**IAS 28.28, 30**

When an investor or joint venturer contributes a non-monetary asset to an associate or joint venture in exchange for an equity interest in that associate or joint venture, the profit or loss resulting from the contribution is recognised in the investor’s or joint venturer’s financial statements only to the extent of the unrelated investors’ and other joint venturers’ interests in the associate or joint venture. However, if the contribution lacks commercial substance, and no other assets have been received, then no gain or loss is recognised at all.

**IAS 28.31, BCZ36**

When an investor in an associate or a joint venturer receives monetary or non-monetary assets dissimilar to the assets contributed, in addition to the equity interest in an associate or joint venture, it recognises in full in profit or loss the portion of the gain or loss on the non-monetary contribution related to those assets received.

**Main change from IAS 28 (2008), IAS 31 and SIC-13**

**IAS 28.BC35**

SIC-13 has been substantially incorporated into IAS 28 (2011). However, not all of its preconditions for gain recognition are included, namely:

- the transfer of significant risks and rewards; and
- the reliable measurement of the gain or loss.

The IASB explains that it has dropped these conditions because either they are not aligned with IFRS 11 or they relate to a criterion for the recognition of gains or losses included in the Conceptual Framework for Financial Reporting.

For the narrow scenario of an associate contributed to a joint venture in exchange for an equity interest in the joint venture, IAS 28 (2011) resolves the conflict between IAS 28 (2008) and IAS 31/SIC-13. Under IAS 31/SIC-13, as a result of such transactions, the joint venturer recognised in profit or loss only the portion of the gain or loss attributable to the equity interest of the other parties, instead of recognising the full gain or loss under IAS 28 (2008). The amendment to changes in interests held in associates and joint ventures resolves this conflict (see 7.3).
Insight – Conflict between IFRS 10 and IAS 28 (2011)

The existing inconsistency in respect of the contribution of a subsidiary to an associate or IAS 31 jointly controlled entity is not resolved by the new suite of standards. Under IFRS 10, when control of a subsidiary is lost, any resulting gain or loss is recognised in full in profit or loss, i.e. no elimination is made in respect of a continuing interest in the assets and liabilities contributed. However, under IAS 28 (2011), an elimination is made in respect of a continuing interest in the assets and liabilities contributed. In our view, this conflict means that the entity should choose one of the following accounting policies, to be applied consistently.

- **The IFRS 10 approach.** Under this approach, no elimination of the gain or loss is performed and the fair value of the retained investment is its deemed cost for the purpose of subsequent accounting.

- **The IAS 28 (2011) approach.** Under this approach, the gain or loss is eliminated to the extent of the retained interest in the former subsidiary.

This issue is discussed in our publication *Insights into IFRS* (3.5.470.20 and 3.5.600.30).

### 7.5 Venture capital organisations

**IAS 28.18**

If an investment in an associate or a joint venture is held by, or is indirectly held through, certain entities, then it may be measured at fair value through profit and loss in accordance with IFRS 9/IAS 39. Those entities are venture capital organisations, or mutual funds, unit trusts or similar entities, including investment-linked insurance funds.

**IAS 28.19**

This election is available for a portion of an investment in an associate that meets that criterion, although the remaining portion would be accounted for under the equity method.

### Main change from IAS 28 (2008) and IAS 31

**IAS 28.BC13**

Previously, the exception for such entities was characterised as a scope exception from the application of IAS 28 (2008) and IAS 31. However, the IASB decided that this exception is more appropriately located as a measurement exception rather than a scope exception. This change appears to have no substantive effect.

However, in addition to changing the placement of the exception, the exception has also been amended to be applicable to a portion of an associate, but not to a portion of a joint venture. The applicability of the exception to a portion of an associate is consistent with our view under IAS 28 (2008) in *Insights into IFRS* (3.5.210).
8. Disclosures

**IFRS 12 Disclosure of Interests in Other Entities**

IFRS 12 sets out the disclosure requirements for interests in joint arrangements and associates. It requires, first, the disclosure of significant judgements and assumptions that an entity has made in determining the nature of its interest, e.g. joint control vs control, and in determining the type of the joint arrangement.

**Insight – Judgement may require disclosure**

This requirement is, in a sense, a re-iteration of paragraph 122 of IAS 1 stated in terms of joint arrangements. What is different now, however, is that IFRS 11’s classification of joint arrangements may in some cases require more judgement than under IAS 31, perhaps sufficiently so to require disclosure.

**IFRS 12.21, 22, B12, B13**

To provide information on the nature, extent and financial effects of interests in joint arrangements and associates, the standard also contains more specific disclosure requirements. These include: name, place of business, relationship with the investor, the proportion owned and the accounting model. Furthermore, IFRS 12 requires quantitative disclosure that includes summarised financial information for at least the following items:

<table>
<thead>
<tr>
<th></th>
<th>Joint ventures</th>
<th>Associates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total current assets</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Non-current assets</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Certain current financial liabilities</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Total non-current liabilities</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Certain non-current financial liabilities</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Depreciation/amortisation</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Income tax expense/income</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Profit or loss from continuing operations</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Post-tax profit or loss from discontinued operations</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Total comprehensive income</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

**IFRS 12.B2-B6, B12**

The summarised financial information is required separately for each material joint venture and each material associate, subject to some aggregation relaxation. Aggregation of the data is permitted for interests in similar entities if the information is not obscured by the aggregation. Information for joint arrangements and associates are presented separately.
ventures cannot, however, be aggregated with information for associates. Similarity (which is the basis of aggregation) may, for example, be based on the nature of activities, industry classification or geography.

**IFRS 12.B14**

The data generally are the amounts included in the IFRS financial statements of the joint venture or associate and do not reflect the entity’s share of the amounts. However, if the equity method is applied (all cases other than venture capital investees – see 7.5), then the data are adjusted to reflect adjustments made by the entity when using the equity method (e.g. as fair value adjustments and adjustments for differences in accounting policies). A reconciliation is required, from the summarised financial information to the investor’s carrying amount of the interest in the joint venture or associate.

**Main change from IAS 31**

These disclosures are much more detailed than those of IAS 31, in particular requiring several specific line items from the statement of comprehensive income. These are given for each material joint venture subject to limited aggregation possibilities; under IAS 31, the disclosures are fully aggregated.

**IFRS 12.B16**

For all individually immaterial joint ventures and associates the following aggregate amounts are disclosed (separately for joint ventures and associates):

- profit or loss from continuing operations
- post-tax profit or loss from discontinued operations
- other comprehensive income
- total comprehensive income.

**IFRS 12.23, B18-B20**

In the context of information on risks associated with interests in joint ventures, total commitments, which may give rise to future outflow of cash or other resources, are disclosed. This is not limited to commitments to contribute funding, but includes, for example, commitments to acquire another party’s ownership interest.
9. Effective date and transition

IFRS 11, IFRS 12 and IAS 28 (2011) are effective for annual periods beginning on or after 1 January 2013.

Early adoption is permitted. An entity early adopting IFRS 11 also is required to adopt IFRS 10, IFRS 12, IAS 27 (2011) and IAS 28 (2011) at the same time and to disclose that fact.

Entities are encouraged to provide information required by IFRS 12 before the effective date. The voluntary early compliance with some of these disclosures would not compel the entity to comply with all of the requirements in IFRS 12 or the remainder of the new consolidated and related standards.

There are no specific transitional requirements included with respect to the transition to IAS 28 (2011). Therefore, under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, IAS 28 (2011) is applied retrospectively. Sections 9.1 to 9.2 discuss the transition from IAS 31 to IFRS 11, which, although retrospective, includes some simplifications for certain transitions.

9.1 Consolidated financial statements

The following diagram illustrates the possible transitions from IAS 31 to IFRS 11 for parties that have joint control over an arrangement. The dotted lines indicate the transitions for which there are specific transitional requirements, which are discussed in further detail below.

9.1.1 Transition from proportionate consolidation to the equity method

At the beginning of the earliest period presented, an entity:

- aggregates the carrying amounts of the individual assets and liabilities previously proportionately consolidated, including any goodwill, into a single amount (the investment’s deemed cost);
- applies IAS 28 (2011) to assess the investment for indications of impairment, recognising any impairment in accordance with IAS 36 Impairment of Assets, as an adjustment to opening retained earnings; and
- discloses a breakdown of the assets and liabilities that comprise the investment, in aggregate for all joint ventures for which this disclosure is provided.
If goodwill was previously allocated to a larger cash-generating unit, or a group of cash-generating units, then it is allocated to the investment in proportion to the relative carrying amounts of the joint venture and relevant cash-generating unit(s).

If aggregation of the individual assets and liabilities previously proportionately consolidated results in negative net assets, then the entity recognises the corresponding liability only if it has a legal or constructive obligation related to the negative net assets. If no liability is recognised, then an adjustment is made to retained earnings at the beginning of the earliest period presented, and the entity discloses that fact and the unrecognised share of losses.

The initial recognition exemption included in IAS 12 Income Taxes does not apply to the recognition of the investment previously proportionately consolidated. Deferred taxes should be recognised for any movements in temporary differences, subject to the exemption for investments in joint arrangements, if applicable. As the recognition of the tax effects follows the transaction or event itself, on transition the effect of such deferred taxes should be recognised directly in equity, i.e. in retained earnings.

In this transition, an entity collapses the proportionately consolidated net asset value (including any allocation of goodwill), less any impairment, into a single investment at the beginning of the earliest period presented.

Although the beginning of the earliest period presented is specified, we assume that this is not meant to be taken literally when the joint venture was only acquired, or attained the status of joint venture, during the comparative period.

Although the accounting value of the investment may change on transition, there will be no effect on the tax base of the individual assets and liabilities previously recognised, or the tax base of the investment itself. After transition, the deferred taxes on the temporary differences arising between the accounting value of the underlying assets and liabilities and their respective tax bases will now be reflected within the equity-accounted investment itself. However, an entity will need to account for the deferred taxes arising from any change in the accounting value of the investment as compared with its tax base, in accordance with IAS 12. The exemption in paragraphs 39 and 44 of IAS 12 for investments in joint arrangements may, however, apply.

At the beginning of the earliest period presented, an entity:

- derecognises the investment previously accounted for using the equity method, including any amounts forming part of the net investment (A);
- measures the initial carrying amount of the assets and liabilities based on their carrying amounts used in applying the equity method;
- recognises its share of each of the assets and the liabilities in the joint operation, including any goodwill that formed part of the investment, based on its rights and obligations in a specified proportion in accordance with the contractual arrangement (B);
recognises any difference between the net investment accounted for using the equity method and the net assets recognised as follows:

- if the net assets recognised are greater than the investment derecognised (if \( B > A \)), then the difference is recognised first against any goodwill related to the investment, with any remaining balance recognised as an adjustment to opening retained earnings; or

- if the net assets recognised are less than the investment derecognised (if \( B < A \)), then the difference is recognised as an adjustment to opening retained earnings; and

provides a reconciliation between the investment accounted for using the equity method and the net assets recognised.

The initial recognition exemption included in IAS 12 does not apply on recognition of the individual assets and liabilities related to the joint operation. Deferred taxes should be recognised for any movements in temporary differences, subject to the exemption for investments in joint arrangements, if applicable. As the recognition of the tax effects follows the transaction or event itself, on transition the effect of any deferred taxes should be recognised directly in equity, i.e. in retained earnings.

Insight – Summary

In this transition, an entity opens up the equity-accounted investment to recognise its share of individual assets and liabilities, including any goodwill, based on the amounts underlying the previous equity method and in accordance with its participation share in the contractual arrangement. In most cases this should be straightforward. However, IFRS 11 anticipates that the aggregate of the newly recognised individual amounts may sometimes differ from the investment derecognised.

When the individual net assets are lower, IFRS 11 requires that in effect the net derecognised value is written off against opening retained earnings. When the individual net assets would be greater, IFRS 11 requires, first, that the goodwill of the joint operation is reduced to bring the newly recognised net assets back to the derecognised figure if possible; and that if the goodwill is fully suppressed, then any remaining net newly recognised value is balanced by a credit to opening retained earnings.

Again, although the beginning of the earliest period presented is specified, we assume that this is not meant to be taken literally when the joint operation was only acquired, or attained the status of joint operation, during the comparative period.

Example – From equity method to assets and liabilities

Previously Company M accounted for a 50 percent interest in a jointly controlled entity using the equity method. On transition to IFRS 11, M determines that it actually has the rights to the assets and obligations for the liabilities of the joint arrangement, i.e. that it is a joint operation. Underlying M’s equity-accounted investment were the following balances, at the 50 percent interest level, at the beginning of the earliest period presented:

<table>
<thead>
<tr>
<th>Asset/ Liability</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>500</td>
</tr>
<tr>
<td>Loans receivable</td>
<td>250</td>
</tr>
<tr>
<td>Goodwill</td>
<td>175</td>
</tr>
<tr>
<td>Trade payables</td>
<td>(125)</td>
</tr>
<tr>
<td>Bank debt</td>
<td>(150)</td>
</tr>
<tr>
<td>Previously recognised unallocated impairment loss</td>
<td>(100)</td>
</tr>
<tr>
<td>Equity-accounted investment</td>
<td>550</td>
</tr>
</tbody>
</table>
M determines that it has rights to all of the assets and obligations for all of the liabilities of the joint operation in proportion to its 50 percent participation share. Therefore, on transition to IFRS 11, M recognises the following entry. Note that the difference between the net investment derecognised (550) and the net assets (650) is recognised against goodwill.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant and equipment</td>
<td>500</td>
</tr>
<tr>
<td>Loans receivable</td>
<td>250</td>
</tr>
<tr>
<td>Goodwill (175 - 100)</td>
<td>75</td>
</tr>
<tr>
<td>Trade payables</td>
<td>125</td>
</tr>
<tr>
<td>Bank debt</td>
<td>150</td>
</tr>
<tr>
<td>Equity-accounted investment</td>
<td>550</td>
</tr>
<tr>
<td><strong>To recognise the underlying assets and liabilities of the joint operation on transition to IFRS 11</strong></td>
<td></td>
</tr>
</tbody>
</table>

If the previously unallocated impairment loss was greater than the carrying amount of goodwill, then any remaining balance would be recognised as an adjustment to retained earnings. However, we expect this to be rare in practice, as it might indicate, for example, that an impairment loss should have been recognised in the investee’s financial statements for its assets, or in the investor’s accounting in respect of fair value adjustments.

**Insight – No transitional requirements for...**

There are no specific transitional requirements for the following transitions; and accordingly, under the provisions of IAS 8, IFRS 11 should be applied retrospectively when making the following transitions:

- **From accounting for the underlying assets and liabilities under IAS 31 to accounting for the underlying assets and liabilities under IFRS 11.** As the accounting is the same under both IAS 31 and IFRS 11, we do not expect significant transitional adjustments.

- **From proportionate consolidation to accounting for assets and liabilities.** In this scenario, the accounting for the investment would change from proportionate consolidation under IAS 31 to accounting for the underlying assets and liabilities under IFRS 11. Generally, we do not expect significant transitional adjustments. There may be some arrangements in which the rights to some assets and liabilities are not the same as the participation interest held and used for the purposes of proportionate consolidation. In these cases, transitional adjustments may be required in order to recognise assets and liabilities based on the entity’s rights and obligations rather than based on its participation interest.

- **From the equity method under IAS 31 and IAS 28 (2008) to the equity method under IFRS 11 and IAS 28 (2011).** The accounting for such investments generally is the same under both IAS 31 and IFRS 11; therefore, we do not expect any transitional adjustments.

**Insight – Other parties to a joint arrangement**

Other parties that participate in, but do not have joint control over, the joint arrangement apply the transitional requirements when relevant. However, not all possible transitions are covered by those requirements, in which case IFRS 11 is applied retrospectively.
9.2 Separate financial statements

The following diagram illustrates the possible transitions from IAS 31 to IFRS 11 in an entity's separate financial statements. The dotted line indicates the transition for which there are specific transitional requirements, which are discussed in further detail below.

### 9.2.1 Transition from IFRS 9/IAS 39 or cost to accounting for assets and liabilities

**IFRS 11.C12**

At the beginning of the earliest period presented, an entity:

- derecognises the investment held at cost or in accordance with IFRS 9/IAS 39;
- recognises its interest in the underlying assets and liabilities at the amounts determined in the manner set out in 9.1.2;
- recognises any difference between the net assets recognised and the investment derecognised as an adjustment to retained earnings; and
- provides a reconciliation between the investment and the net assets recognised.

**IFRS 11.C13, IAS 12.15, 24, 39, 44, 57**

The initial recognition exemption included in IAS 12 is not applicable on recognition of the individual assets and liabilities related to the joint operation. Deferred taxes should be recognised for any movements in temporary differences, subject to the exemption for investments in joint arrangements, if applicable. As the recognition of the tax effects follows the transaction or event itself, on transition the effect of recognising any deferred taxes should be recognised directly in equity, i.e. retained earnings.

**Insight – Generally no difference between consolidated and separate financial statements**

**IFRS 11.BC67**

It appears as though there should be no difference between the amount recognised in the parties’ consolidated financial statements and their separate financial statements. Therefore, on transition, it seems as though an entity should recognise the underlying assets and liabilities arising from the joint operation at the amounts recognised in the consolidated financial statements, with any difference between the investment derecognised and the net assets recognised as an adjustment to retained earnings.
An issue may arise if the entity does not prepare consolidated financial statements. In such scenarios, the entity appears to be required to recognise its interest in the underlying assets and liabilities as if consolidated financial statements were prepared in which the investment was accounted for using the equity method. Determining these amounts may be particularly difficult when the investment was never accounted for using the equity method, although it may be possible that the investment was accounted for using the equity method by a higher parent. However, these amounts may need to be adjusted for the entity to use them.

9.3 First-time adopters of IFRSs

Generally, a first-time adopter is permitted to use the transitional requirements discussed in 9.1 and 9.2 when adopting IFRSs. However, when a first-time adopter is making the transition from accounting for a joint venture using proportionate consolidation to using the equity method (see 9.1.1), the first-time adopter is required always to test the opening balance of the investment for impairment, i.e. regardless of whether there is an indication of impairment. Any impairment losses are recognised as an adjustment to retained earnings at the beginning of the earliest period presented.

9.4 Other effects of adopting IFRS 11

The transition to IFRS 11 may result in a change in classification of an existing joint arrangement or the identification of a new joint arrangement. An entity should consider whether a third statement of financial position is required on transition to IFRS 11.

Insight – Third statement of financial position

Our publication Insights into IFRS (2.1.35) provides guidance on cases in which a third statement of financial position and the related notes are required.

9.5 Disclosure requirements before adoption

When an entity has not adopted a new IFRS that is not yet effective, IAS 8 requires it to disclose that fact and provide information relevant to assessing the potential impact of adopting the new standard. This includes the following information:

- the title of the new IFRS;
- the nature of the impending change or changes in accounting policy;
- the date by which application of the IFRS is required;
- the date as at which it plans to apply the IFRS initially; and
- either:
  - a discussion of the impact that initial application of the IFRS is expected to have on the entity’s financial statements; or
  - if that impact is not known or reasonably estimable, then a statement to that effect.
Insight – Assessing the effect of IFRS 11

Before its application, preparers will need either to assess quickly the effect of IFRS 11 on their financial statements and provide the required information, or to disclose the fact that they are not able to assess the impact of the adoption of IFRS 11. We expect most preparers not to be able to assess the effect of IFRS 11 when the suite of consolidation standards is first issued. When more analysis is done and preparers begin to obtain an understanding of the potential effect of applying the standard, those disclosures may need to be updated.
# Appendix 1: Changes in interests held

The following table illustrates the possible changes in the status of investments in associates and joint ventures (equity-accounted investments), changes in the interest held in those investments without a change in status and the required accounting for each of those changes. The shaded box is the area in which the provisions of IAS 28 (2011) change current requirements or practice.

<table>
<thead>
<tr>
<th>From: Financial assets</th>
<th>To: Financial assets</th>
<th>Equity-accounted investments</th>
<th>Consolidation</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>Gain or loss for the difference between (i) sum of the fair value of any retained investment and any proceeds on disposal; and (ii) the carrying amount of the investment at the date the investor loses significant influence/joint control. Retained investment initially measured at fair value for the purpose of applying IFRS 9/IAS 39. All reserves reclassified or transferred, as the case may be (IAS 21.48A, IAS 28.24(b), 24(c) and our publication Insights into IFRS at 3.5.750.30-60).</td>
<td>Increase in interest: no remeasurement of retained interest. Reserves are not reclassified to profit or loss or transferred to retained earnings (IAS 28.25, 26). Decrease in interest: no remeasurement of retained interest: Gain or loss from the decrease in interest is recognised in profit or loss. Reclassification or transfer, as the case may be, on a proportionate basis (relative to the decrease of interest), of gains or losses previously recognised in other comprehensive income (IAS 21.48C, IAS 28.26 and our publication Insights into IFRS at 3.5.730).</td>
<td>Remeasurement of previously held interest at fair value through profit or loss. All reserves reclassified or transferred, as the case may be (IFRS 3.42, IAS 28.24(a)).</td>
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The standards do not provide any specific requirements. Our preferred view: remeasurement of previously held interest at fair value through profit or loss. Available-for-sale reserve reclassified to profit or loss (our publication Insights into IFRS at 3.5.700). Acceptable alternative: cost method. Available-for-sale revaluation reserve transferred to retained earnings (our publication Insights into IFRS at 3.5.710). Remeasurement of previously held interest to fair value through profit or loss. Available-for-sale reserve reclassified to profit or loss (IFRS 3.42).
## Financial assets

Measure retained interest at fair value and reclassification or transfer, as the case may be, of all reserves (IAS 27.34, 35, IAS 21.48, 48A(a)).

## Equity-accounted investments

Measure retained interest at fair value and reclassification or transfer, as the case may be, of all reserves (IAS 27.34, 35, IAS 21.48, 48A(a)).

## Consolidation

Transactions with non-controlling interests (IAS 27.30, 31); comprehensive income unaffected; subsidiary’s net assets and goodwill unaffected.

Re-attrition of reserves between parent and non-controlling interests (IAS 27.31, IAS 21.48C and our publication *Insights into IFRS* at 2.5.380).

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In the table the terms ‘reclassification’, ‘transfer’ and ‘as the case may be’ have the following meanings.

- **Reclassification**: from other comprehensive income to profit or loss.
- **Transfer**: between accounts within the equity, without affecting, for example, profit or loss.
- **As the case may be**: whether an item is reclassified or transferred follows the manner in which it would be treated on derecognition of the balance sheet item to which it relates.
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our First Impressions publications are prepared on the release of a new IFRS, interpretation or other significant amendment to the requirements of IFRSs. They include a discussion of the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to assist in assessing the impact of implementation.

This edition of First Impressions considers the requirements of IFRS 11, together with the related aspects of IFRS 12 and IAS 28 (2011).

The text of this publication is referenced to IFRS 10, IFRS 11, IFRS 12, IAS 27 (2011) and IAS 28 (2011), and to selected other current IFRS literature, standards and interpretations, in issue at 15 May 2011. References in the left-hand margin identify the relevant paragraphs of the standards and interpretations.

In many cases further interpretation will be needed in order for an entity to apply IFRSs to its own facts, circumstances and individual transactions. Further, some of the information contained in this publication is based on the initial observations of IFRSs developed by the KPMG International Standards Group, and these observations may change as practice develops.

We will update and supplement the interpretative guidance and examples in this publication by adding additional interpretative guidance to Insights into IFRS, our practical guide to IFRSs. References throughout this publication are made to the 2010/11 edition of Insights into IFRS.

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We would also like to thank the contributions made by reviewers, which includes other members of the Business Combinations and Consolidation Topic Team:

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