

Practical guide to IFRS

Joint arrangements: a significant issue for the real estate and construction industry

What is the issue?

The International Accounting Standards Board issued IFRS 11, 'Joint arrangements', in May 2011, which overhauls the existing accounting for joint arrangements. 'Joint arrangements' is the new umbrella term for all arrangements where joint control is present.

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IFRS 11 provides investors with greater clarity about an entity's involvement in joint arrangements by requiring entities to recognise the rights and obligations arising from their joint arrangements. Parties to a joint operation should recognise on the balance sheet their rights and obligations arising from the arrangement as assets and liabilities. Parties to a joint venture should apply equity accounting.

More information on the detailed requirements of the standard is available in the [Practical guide to IFRS: Joint arrangements – a new approach to an age-old business issue](#), which can be downloaded from www.pwc.com/ifrs.

This supplement considers the business and industry-specific issues associated with IFRS 11 that management should consider. For example, management will need to evaluate how the standard will affect the way they account for their existing or new joint arrangements; and how their current business activities may need to change beyond the accounting processes, such as key business metrics (for example, debt covenants), controls and processes, information-gathering and information technology requirements.

Joint arrangements continue to be used in the real estate and construction industry

The real estate industry has often used joint arrangements in structuring its business and operations. It provides entities with a mechanism by which to:

- manage their exposure to particular geographical regions and asset classes;
- share risks in relation to the ownership and/or development of property ; and/or
- leverage the expertise , experience and knowledge of the joint arrangement partners.

The structuring of joint arrangements in the real estate and construction industry varies from straight-forward arrangements (for example, direct joint ownership of property assets) to more complicated arrangements (for example, joint arrangements to develop and construct property structured through separate vehicles and subject to various contractual agreements). It is therefore critical for management to understand not only the structure of the arrangements but the contractual terms in order to assess the impact of IFRS 11 in accounting for these arrangements. Some arrangements are not expected to be affected, but the accounting for others may be significantly affected, as the legal form is no longer the focal point and accounting options have been removed.

Why is this issue significant for the real estate and construction industry?

The new standard will affect some entities and industries more than others, although all entities with joint arrangements should expect some level of change. Entities in the real estate and construction industry that are likely to be most significantly affected include those that:

- enter into new joint arrangements;
- apply proportionate consolidation for joint venture entities;
- participate in a significant number of complex joint arrangements; and
- have former joint arrangements with limited documentation detailing the terms of the arrangement.

We expect IFRS 11 to affect a significant number of entities in the real estate and

construction industry because joint arrangements are commonplace. They generally allow entities to share the risk and expense of projects; facilitate access to new geographies; provide benefits from new expertise; and often ensure the retention of tax benefits.

In practice, joint arrangements take many forms. Individual arrangements will need to be understood in order to apply this to the new guidance.

IFRS 11 also introduces new financial statement presentation requirements. These will be particularly relevant for entities in the real estate and construction industry where identifying their share of revenue or expenses is important to stakeholders and/or where their gross balance sheet does not currently consider the specific rights and obligations associated with the joint arrangement.

Three key areas of focus under IFRS 11

1. Classification of a joint arrangement	
Key change (snapshot)	Impact on IFRS financial statements
<p>The standard requires entities to assess their rights and obligations under the joint arrangement in order to determine the appropriate classification as either a 'joint operation' or 'joint venture'.</p> <p>The accounting for a joint arrangement will no longer be driven solely by its legal form.</p> <p>Operators will account for their involvement in a joint arrangement in a manner that is consistent with their rights and obligations.</p>	<p>A joint operation is a joint arrangement that gives parties to the arrangement direct rights to the assets and obligations for the liabilities. A joint operator will recognise its interest based on its involvement in the joint operation (that is, based on its direct rights and obligations) rather than on the participation interest it has in the joint arrangement. The balance sheet and income statement will be presented gross.</p> <p>A joint venture, in contrast, gives the parties rights to the net assets of the arrangement. A joint venturer does not have rights to individual assets or obligations for individual liabilities of the joint venture. Instead, joint venturers share in the net assets and the outcome (profit or loss) of the activity undertaken by the joint venture. Joint ventures are accounted for using the equity method in accordance with IAS 28, 'Investments in associates'. The net investment in the venture is a single line in the balance sheet and the profit appears in a single line in the income statement.</p>

Industry insight

Investment property that is directly owned as 'tenants in common', and not through a separate vehicle, is likely to meet the joint operation classification.

Investment property or development projects undertaken through a separate vehicle – such as a trust, company or unincorporated partnership – will need to be carefully assessed. The legal form of the arrangement is no longer the focal point, but rather the rights and obligations of the participants; as such, it is important to understand the contractual terms of the agreements.

2. No proportionate consolidation for joint ventures

Key change (snapshot)

The standard requires joint ventures to be accounted for using the equity method. Previously, a venturer could choose to proportionately consolidate its ownership interest in the joint venture.

Impact on IFRS financial statement

Equity accounting will apply to all joint ventures. A single line item will be shown in the consolidated income statement to reflect the share of profit or loss in the joint venture, and a single line item will be shown in the consolidated balance sheet to reflect the share of net assets in a joint venture.

Industry insight

Management in the industry often views their property development portfolios on a 'look-through' basis – that is, they analyse and review the performance of not only the portfolio that is directly held but also those held jointly through separate vehicles. Proportionate consolidation resulted in financial reporting that was aligned to management's approach.

However, where the joint arrangements are classified as joint ventures under IFRS 11, management will no longer have an accounting choice and will be required to apply equity accounting for the joint arrangement.

Management will need to communicate this change to stakeholders, as it will result in the netting of balances into a single line item on both the consolidated income statement and consolidated balance sheet. Management should also consider how this may impact the calculation of their covenants, and hold discussions with their lenders where this is expected to have an impact.

3. Transition

Key change (snapshot)

Management should re-evaluate the terms of their existing contractual arrangement to ensure their involvement in joint arrangements are correctly accounted for under IFRS 11.

Impact on IFRS financial statement

Joint arrangements that were previously accounted for as joint operations may need to be treated as joint ventures or vice versa on transition to the standard.

A change in the classification of a joint arrangement will require all parties to the joint arrangement to change the way they report their respective rights and obligations in their financial statements.

When transitioning from the proportionate consolidation method to the equity method, management should recognise its initial investment in the joint venture as the aggregate of the carrying amounts that were previously proportionately consolidated.

To transition from the equity method to accounting for a joint operation, management derecognises its investment in the joint arrangement, and recognises its rights and obligations to the assets and liabilities of the joint operation.

Industry insight

Management should be proactive in understanding the contractual terms attaching to existing joint arrangements prior to transition, as retrospective application is required. This will ensure that they can analyse and assess the impact of the new standard and determine the appropriate accounting required.

Management should also consider the structure of future joint arrangements and understand how IFRS 11 changes the accounting for these.

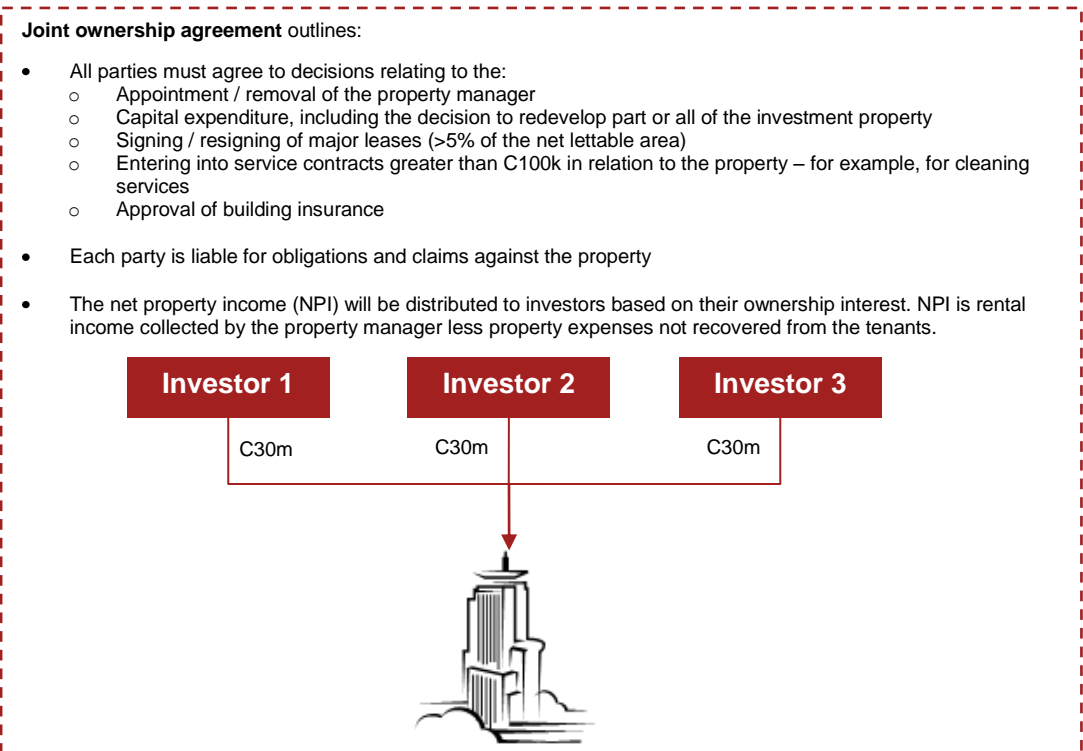
Examples: illustration of key impacts in real estate and construction industry

Scenario 1

An investment property with a value of C90m was purchased by three investors. Each investor has an equal interest in the property and is listed as a tenant in

common on the title deed. Each investor has funded their interest individually, either through external borrowings or capital. A joint ownership agreement has been signed between the investors to govern their joint ownership of the investment property.

The arrangement is depicted as follows:



Current accounting. The above was accounted for as a jointly controlled asset under IAS 31, ‘Interests in joint ventures’.

New accounting. The above is a joint operation under IFRS 11. The investors sharing in the NPI of the investment

property does not preclude it from being a joint operation, as each investor has direct rights to the investment property and is liable for obligations and claims arising. There is no change in the accounting as a result. Each investor will continue to recognise their share of:

- the investment property;
- tenants receivables outstanding at period end;
- trade creditors and accruals outstanding at period end;
- property expenses incurred during the period; and
- rental income generated during the period.

Each investor will also recognise the respective borrowings or additional capital obtained in order to fund the acquisition in their financial statements.

Challenges in practice. Arrangements that previously fit within IAS 31's jointly controlled assets category are likely to qualify as joint operations under IFRS 11; however, management will need to assess each arrangement to confirm this presumption.

Scenario 2

ABC real estate company was established in the current year by investors 1 and 2, who own 60% and 40% respectively.

The company owns and operates a diversified property portfolio, which it has funded through external borrowings and capital contributed by investors 1 and 2. The legal form of the company restricts the liability of investors to any unpaid capital contributions. Creditors of the company have no recourse against the investors.

The company's articles of association outline that an 85% majority is required for decisions regarding the relevant activities of the company. Each investor votes in proportion to their ownership interest; as such, both investors 1 and 2 must unanimously agree on decisions in relation to the company.

Current accounting. The above is accounted for as a jointly controlled entity under IAS 31. IAS 31 allows an accounting policy choice – the interest in the company can be recognised using either the equity accounted method or proportionate consolidation. Both investors have elected to proportionately consolidate the company. Their share of

the consolidated balance sheet and income statement is incorporated into their financial statements on a line-by-line basis.

New accounting. The above is a joint venture under IFRS 11. The company is a separate vehicle, which confers separation between the investors and the company itself – that is, the investors are only entitled to the net assets of the company.

Proportionate consolidation is not an available accounting choice under IFRS 11. Both investors will be required to equity account their interest in the joint venture.

Challenges in practice. This represents a significant change and will result in the netting of the investors' consolidated balance sheet and income statement to single line items. Management will need to consider how the changes to the landscape of balance sheet and income statements will impact areas such as:

- compliance with loan covenants and ratios;
- achievement of key performance measures and metrics; and
- the calculation of performance incentives, where these are driven from income statement and/or balance sheet figures.

Management should also consider how the change will be communicated to stakeholders, and how information on a look-through basis (which is common in the industry) may be presented. For example, will management communicate this through analyst or investor briefings? Alternatively, where management continues to review the operations on a look-through basis, this information will continue to be captured as part of the segment note disclosures (where applicable).

Alternatively, management may wish to consider changing the terms and conditions or structure of their joint arrangements, in conjunction with the others parties, to ensure continuity in how they account for their joint arrangements.

Scenario 3

Two parties have entered into an arrangement to develop a parcel of land into residential housing.

Company A currently owns the land that will be developed as part of the joint arrangement. It will also undertake the development activities in order to construct the residential housing for a fee. Company A will retain legal title of the land. A development deed is entered into between both companies that provides a beneficial interest in the land to company B. As a result, both Company A and B will have a direct right to the land.

Company B identified the opportunity to partner with company A and will provide capital to the arrangement.

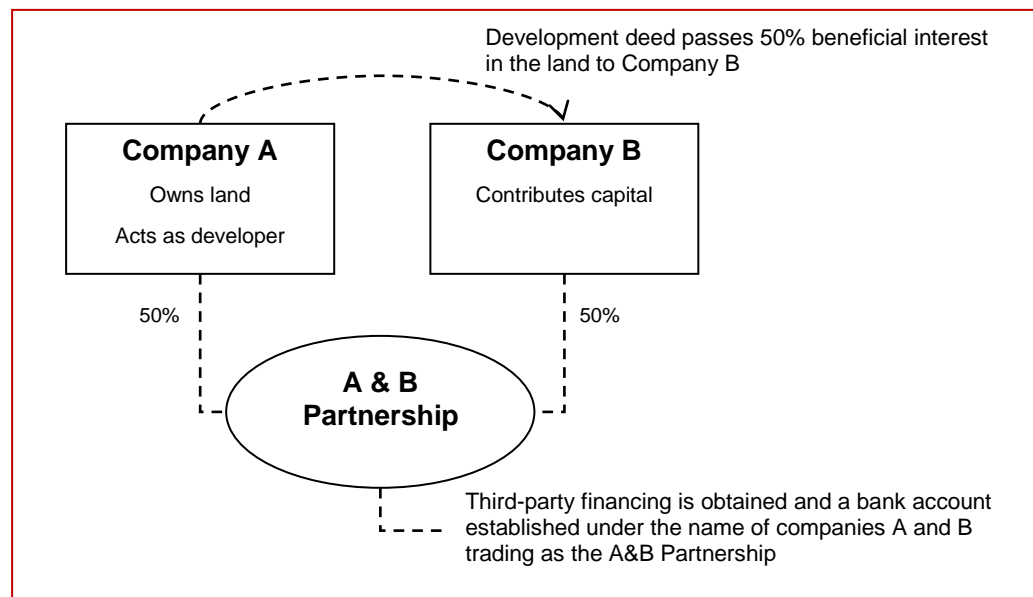
Companies A and B have established an unincorporated partnership to undertake the activities of the joint

arrangement. The unincorporated partnership does not create legal separation between the entity itself and company A and B.

Third-party financing has been obtained by companies A and B trading as the A&B Partnership. The financing is secured against the land subject to development; however, A and B still have a direct obligation for the third-party financing.

A bank account has also been established by companies A and B trading as the A&B Partnership. All payments for the development and receipt of sales proceeds will pass through this bank account.

Separate books and records are maintained for the A&B Partnership, and financial statements are prepared on an annual basis for distribution to both companies.



Current accounting. The A&B Partnership has a separate financial structure, as indicated by:

- the separate financing arrangements;
- the separate bank account; and
- the separate books and records maintained for the partnership.

As a result, the above is accounted for as a jointly controlled entity under IAS 31. Both companies have elected to equity account for their interest in the A&B Partnership.

New accounting. The above is a joint operation under IFRS 11. While the A&B Partnership is a separate vehicle, companies A and B have direct rights to the assets and obligations for the liabilities of the partnership. Each company will recognise its share of the arrangement's assets, liabilities, revenues and expenses.

Challenges in practice. The legal structure of an arrangement is no longer the most significant factor in determining the accounting. Understanding the respective rights and obligations may be challenging, and arrangements need to be carefully considered.

Where on transition, the classification of a joint arrangement changes, it is important to consider the impact on the presentation of the entity's balance sheet and income statement. Scenario 2 outlines a number of areas to be considered by management.

What are the potential effects on the real estate and construction industry?

- Changes to the classification of joint arrangements may result in significant financial changes for entities. This could impact the recognised amounts in profit and loss (for example, revenues and expenses) as well as the balance sheet presentation. For example, leverage, capital ratios, management incentives, covenants and financing agreements may be affected as a result of changes to the balance sheet, particularly when moving from the equity accounting

approach to the share of assets and liabilities approach. Such impacts should be reviewed in advance to understand how an entity's balance sheet may be affected.

- Management should consider how to communicate the impacts of the accounting changes to shareholders and other stakeholders. There could be important changes to the manner in which the entity's interest in the joint arrangement is reported and understood by users of the financial statements.
- Future deal-structuring should be considered with the new rules in mind. For example, a joint arrangement in a corporate wrapper would not necessarily give rise to a joint venture, but the specific terms of the arrangement would still need to be analysed in order to understand the entity's rights and obligations under the agreement.
- Investors may need to request more detailed financial reporting information from an operator of a joint operation if the operator moves from equity accounting to the share of assets and liabilities approach. Similarly, management may need to provide more detailed information to other parties if they are the operator of a joint operation. For example, an operator may need to provide information concerning the maturity profile of financial liabilities to allow appropriate classification on the balance sheet of the investor or understand the assumptions applied in measuring assets at fair value (such as investment property). Operators may also be required to provide this information at numerous points during a reporting cycle, as investors may have different reporting dates, which could increase their reporting obligations.
- In some countries, non-domestic operators are obliged to have a local partner. It can be challenging to obtain detailed financial information on a timely basis from these businesses, and moving from equity accounting to share of assets and liabilities could be complex.

- Existing systems that integrate joint arrangement accounting may be in place. Any changes to the accounting should be understood to ensure the accounting application of any systems used can also be updated on a timely basis.
- Initial transition requirements and annual reassessment of arrangement terms may require changes to existing processes and internal controls. Gathering and analysing the information could take considerable time and effort, depending on the number of arrangements in place, the inception dates and the records available. Where significant changes

to financial results and financial position arise, management should communicate these effects to stakeholders as soon as possible. Timely assessment and management of all of the potential implementation and ongoing business impacts of IFRS 11 will help reduce unexpected business and reporting risks. Beginning this process early will allow management enough time to consider potential adoption strategies or to renegotiate agreements in order to reduce the impact of adoption and to achieve preferred classification outcomes for future arrangements.

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