

Impact of new HKFRSs on joint arrangements in China

Lee Yin-toa and Laurence Carabin explain how recently effective standards affect the disclosure of relationships between entities

The Hong Kong Institute of CPAs issued three new standards during 2012: HKFRS 10 *Consolidated Financial Statements*, HKFRS 11 *Joint Arrangements* and HKFRS 12 *Disclosures of Interests in Other Entities*. These standards aim to increase the consistency, transparency and comparability of accounting and disclosures of relationships between entities.

They also intend to better reflect the economic substance of these arrangements. Thus the assessment of accounting is required to extend beyond the legal structure and well into the nature of rights and obligations under the arrangements.

This article specifically focuses on HKFRS 11, which replaces HKAS 31 *Interests in Joint Ventures* and SIC 13 *Jointly Controlled Entities - Non-Monetary Contributions by Venturers*.

One of the significant differences between HKFRS 11 and HKAS 31 lies in the question of what drives accounting for arrangements between two or more parties.

In HKAS 31, the legal form of the entity through which arrangements were structured was the sole driver of accounting.

On the other hand, in HKFRS 11, accounting is driven by the core principles that parties should recognize their rights and obligations, using either proportionate consolidation (gross accounting of rights to assets and obligations for liabilities) or the equity method (accounting for net assets arising from arrangements).

As a consequence, HKFRS 11 eliminates the accounting policy choice when account-

ing for investments in structures defined as joint ventures.

In this article, we first identify the entities most likely to be affected, especially those doing business via joint ventures in China; explain the main modifications in identification, classification and measurement; and analyse both the financial and business implications.

Businesses affected

Entities most likely to be affected by changes include those that operate in construction, real estate, oil and gas or mining industries that commonly participate in joint arrangements. In addition, many companies doing business in China will be affected, whatever the sector. China is the country with the second largest number of joint venture transactions (after the United States), given the high level of foreign direct investments.

Because Beijing requires Chinese company participation or control in some sectors, especially regulated and defensive industries such as automotive, energy, financial services, pharmaceutical and telecommunications, most foreign companies set up a joint venture structure. Even when they are not required, joint ventures are considered when a Chinese partner has certain strengths, such as central or local government support, brand reputation, land, licences, distribution and access to suppliers, which reduce start-up costs and improve the foreign investor's chances of success.

The popularity and attractiveness of joint transactions in China makes HKFRS 11 a bigger challenge in this part of the world.

Definition

A "joint arrangement" is defined in HKFRS 11 as a contractual arrangement in which two or more parties have joint control. The scope of HKFRS 11 remains the same despite the change in the standard's terminology from "joint ventures" to "joint arrangements" that might suggest otherwise. The term "joint venture" is commonly used in practice; however, HKFRS 11 narrowly defines it as just one of two types of joint arrangements.

Identification

The initial step is for entities to determine if an arrangement is within or outside the scope of HKFRS 11. The question is whether there is joint control, which HKFRS 11 defines as "the contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control." Given this definition, management will need to carefully assess the three key aspects of joint control: (1) contractually agreed, (2) control and relevant activities and (3) unanimous consent.

For instance, it is the norm that contractual agreements are written, but not always. Sometimes, only general principles are agreed on but not specific terms that could help in assessing whether there is joint control. This is especially common in China, where the legal framework is not as well established as international standards. There are also the complications rising from related party transactions with government entities that are implicit rather than explicit in contractual agreements.



Furthermore, it is not always clear at what level to assess a joint arrangement to determine if joint control exists, for instance in the case of a master agreement – a single contract with terms and conditions for numerous entities and activities. In order to assess whether a party has control, entities should familiarize themselves with the new rules in HKFRS 10.

Meanwhile, unanimous consent exists when the parties have collective control over the arrangement and no single party has control. In fact, contractual arrangements may not always be explicit to sufficiently demonstrate existence of unanimous consent.

No matter what terminology is used to describe the arrangement, only if all three requirements for joint control are present would the arrangement be considered a joint arrangement. Otherwise, the arrangement falls outside the scope of HKFRS 11.

Classification

Once a joint arrangement is considered as present and identified, we can look at its classification: either as a joint venture or a joint operation. Unlike in HKAS 31, structure or legal form is not the sole factor in determining classification. HKFRS 11 focuses also on the nature and substance of rights and obligations arising from the arrangement.

If a joint arrangement is not structured through a separate vehicle, it is a joint operation. If it is so structured, the entity

should further assess whether the legal form of the separate vehicle, terms of the contractual arrangements and/or other facts and circumstances (commitments, restrictions, finance, guarantees and responsibilities) extend to the parties' rights to the assets and obligations for liabilities of the arrangement. Should this be the case, the arrangement also qualifies as a joint operation; otherwise, such an arrangement may be considered a joint venture.

Measurement

The classification will lead to a different treatment in the financial statements. A joint operator will recognize its share of assets, liabilities, revenues and expenses. On the contrary, joint venturers will use the equity method, as the Institute removed the option of proportionate consolidation. Joint venturers would then have to change their accounting, depending on their arrangements.

Business impact

Many jointly controlled entities expect to be classified as joint ventures, even more so when doing business in the Mainland. Indeed, most Chinese joint ventures are currently established as “equity joint ventures” with a separate legal person under PRC law, and profit, control, and risk are divided in proportion to the equity shares invested by the parties. HKFRS 11, combined with the intention to keep proportionate consolida-

tion, could lead to the conclusion of “contractual joint ventures” which are also called cooperative agreements. In this case, profit, control, and risks are divided according to negotiated contract terms.

Financial impact

In case HKFRS 11 leads to a shift from proportionate consolidation to the equity method, management should consider how key financial metrics would be impacted. As a consequence, the investment in the joint venture will be captured in a single line item in the financial statement position.

Total assets and liabilities will decrease to the extent of the entity's previously recognized share in the individual assets and liabilities of the joint venture. The removal of the entities' proportionate share of debt could cause the financial leverage ratio to be smaller, including gearing.

Concerning the profit or loss, there will be no change in net income. However, total revenue and total expenses will decrease, which could affect the total asset turnover ratio, depending on the absolute and relative changes of revenue and assets.

Conclusion

Entities should exercise an appropriate level of care in accounting for their rights and obligations under HKFRS 11. This new standard has removed some “bright lines” and led to the exercise of considerable judgment. Accountants are therefore not able to make conclusions alone and should invite input from operations and legal counsel as well as close involvement by management.

Management should also consider the requirements of HKFRS 11 when negotiating new contracts or modifying existing arrangements. In certain cases, audit committees and independent auditors need to discuss material areas and document key discussions.

Contractual arrangements should be analysed thoroughly, and accountants should develop robust accounting policies and modify performance metrics and debt covenants. It should be noted that 1 January is the mandatory adoption date for calendar year-end companies.



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