

A tall construction crane is the central focus, extending from the bottom left towards the top left. The crane has a long, silver, cylindrical tower with several circular openings. At the top, there is a complex structure with various platforms and equipment. In the background, a city skyline is visible under a clear sky, with several buildings of varying heights. A bright yellow diagonal stripe runs from the bottom right towards the top right, partially overlapping the crane and the city. The overall scene is a construction site in an urban environment.

IFRS 10, 11 and 12 on consolidation and joint arrangements

A changing balance sheet

Implications for the real estate and construction industries



Contents

1. Introduction	2
2. Principal impacts of the new standards	2
3. Consolidation	3
3.1 Asset or fund managers	3
3.1.1 Scope of decision making authority	3
3.1.2 Rights held by others	4
3.1.3 Remuneration of the asset manager	4
3.1.4 Variable returns held through other interests	5
3.2 Structured entities (special purpose entities)	6
3.3 Exception for consolidation of controlled investments by 'investment entities'	6
3.4 Conclusion	6
4. Joint arrangements	7
4.1 Introduction	7
4.2 Unit of account	7
4.3 Joint ventures	7
4.4 Joint operations	8
4.5 Venture capital organisations and similar entities	8
4.6 Summary	8
5. Final thoughts	8



1. Introduction

Three new standards have recently been released by the International Accounting Standards Board (IASB): IFRS 10 *Consolidated Financial Statements*, IFRS 11 *Joint Arrangements*, and IFRS 12 *Disclosure of Interests in Other Entities*.

What you need to know

- ▶ IFRS 10 includes a new definition of control that determines which entities are consolidated. IFRS 10 replaces the part of IAS 27 *Consolidated and Separate Financial Statements* related to consolidated financial statements and replaces SIC 12 *Consolidation – Special Purpose Entities*.
- ▶ IFRS 11 describes the accounting for arrangements in which there is joint control; proportionate consolidation is not permitted for joint ventures (as newly defined). IFRS 11 replaces IAS 31 *Interests in Joint Ventures* and SIC 13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*.
- ▶ IFRS 12 sets out the disclosure requirements for subsidiaries, joint ventures, associates and “structured entities.” IFRS 12 replaces the requirements previously included in IAS 27, IAS 31, and IAS 28 *Investments in Associates*.

These IFRS are effective for annual periods beginning on or after 1 January 2013. IFRS 11 is part of the convergence project with the US Financial Accounting Standards Board (FASB). However, the FASB is still considering convergence with respect to certain aspects of IFRS 10, and differences are likely to remain to US GAAP even after any further changes are made.

In this publication, we concentrate on the implications of these new IFRS for the real estate and construction industries. Refer to *IFRS Developments – IASB issues three new standards: Consolidated Financial Statements, Joint Arrangements, and Disclosure of Interests Other Entities, Issue 1 (IFRS Developments, Issue 1)* for a more complete summary of these new standards. IFRS Developments are available at www.ey.com/IFRS.

2. Principal impacts of the new standards

The adoption of IFRS 10 and IFRS 11 may lead to significant changes in an entity's reported financial position and performance. For some companies, the new definition of control will lead to consolidation of entities that were not previously included in the group, potentially resulting in more assets and liabilities on the books. There may also be instances in which companies will have to de-consolidate entities that were previously consolidated, that is, taking those entities off the balance sheet, although this is expected to be rare.

Similarly, some joint arrangements that are accounted for using proportionate consolidation under current IFRS will be accounted for using the equity method under IFRS 11. This will result in recognising a single line item for the investment and the reporting entity's share of the joint arrangement's profit or loss. Conversely, there might be some joint arrangements that are currently accounted for using the equity method that will be considered joint operations under the new standard. For those arrangements, the joint operator will recognise its assets, liabilities, revenues, and expenses, and/or its share of those items, if any; that is, the single investment line item will have to be disaggregated into its components on the balance sheet and income statement.

A common feature of both IFRS 10 and IFRS 11 is that they require considerably more judgement than was required under the previous standards, and they remove some of the existing bright lines.

In the following sections, we look at how IFRS 10 and IFRS 11 could impact the real estate and construction industries. For the ramifications of IFRS 12, refer to *IFRS Developments, Issue 1*.



3. Consolidation

For the real estate and construction industries, it is likely that the greatest impact of IFRS 10 will be on asset or fund managers, structured entities and investment entities.

3.1 Asset or fund managers

IFRS 10 may require some asset or fund managers (the 'asset manager') to consolidate the asset or funds into their own financial statements. Consolidation is required if the asset manager controls the fund, which is the case if the asset manager has:

- ▶ Power over the investee
- ▶ Exposure, or rights, to variable returns from its involvement with the investee
- ▶ Ability to use its power over the investee to affect the amount of the returns to the asset manager

In most cases, it is clear when all three criteria have been met. However, before concluding that an asset manager controls a fund, it needs to determine whether it holds power over the investee as a principal, or simply as an agent. This assessment is particularly difficult when the investor manages a fund in which it also invests. In such cases, consideration should be given to the range of activities that the asset manager is permitted to direct, and the level of discretion allowed in making such decisions.

However, an asset manager can have control (be a principal) even without having a direct financial interest in a fund, such as a direct equity investment (or debt investment). For example, if the asset manager had a broad scope of decision-making authority, cannot be removed, and/or its remuneration is very large with respect to the returns of the investee – it is possible that the asset manager would be a principal. However, the IASB is considering an exception for certain investment entities, which is discussed in section 3.3 below.

Careful consideration will thus be required to assess whether an asset manager acts as a principal (and, therefore, may need to consolidate the fund) or as an agent (in which case, it recognises only its direct interest and its management fee). The factors to be considered include, but are not limited to:

- ▶ Scope of the asset manager's decision making authority
- ▶ Rights held by others (e.g., protective, removal rights or kick-out rights)
- ▶ Exposure to variability in returns through the remuneration of the asset manager
- ▶ Variable returns held through other interests (e.g., direct investments by the asset manager, credit enhancements, liquidity facilities)

Below, we focus on each of these concepts. When considering these factors, IFRS 10 also requires management to consider whether there are other parties who are acting on behalf of an investor by virtue of their relationship with the investor, that is, whether the other parties are acting as *de facto* agents of the investor.

3.1.1 Scope of decision making authority

The scope of an asset manager's decision-making authority is evaluated by considering the range of activities that it is permitted to direct and the discretion that it has when making decisions about those activities.

An asset manager does not usually have discretion to make changes either to the activities that it is permitted to direct, or to the decisions that it is permitted to make without the prior approval of the other investors in the fund. This would generally indicate that it is an agent acting in a fiduciary capacity. However, consideration must also be given to the level of involvement the asset manager has in determining the scope of its authority: that involvement may indicate that the asset manager has the opportunity and incentive to obtain the ability to direct the relevant activities, which could indicate that the asset manager is a principal.

The scope of decision making authority must be considered together with the other factors below.



3.1.2 Rights held by others

In determining whether an asset manager is a principal or an agent, the asset manager also has to consider whether other parties hold rights that would affect any powers that have been delegated to the asset manager. For example, a removal or kick-out right held by the investors might affect the asset manager's decision-making ability.

If one party (investor) holds a removal right (that is, a single investor can decide to kick out the asset manager), and that right is substantive, then the asset manager is considered an agent. However, if their exercise requires agreement by more than one party, then it is not conclusive as to whether the asset manager is a principal or an agent. The more investors that would have to agree to remove the asset manager, the less important that removal right is, when determining if the asset manager is a principal.

In some cases, investors might hold rights that are merely protective rights. Protective rights are those that relate to fundamental changes in the business, or are exercisable only when specified circumstances arise or events occur. If the rights are deemed protective rights, they do not give that party the ability to direct the activities of an entity that significantly affect returns, that is, they do not give that investor power, and therefore no control. For example, many real estate funds have a pre-determined investment strategy, which is usually outlined in the offer document. Changes to that strategy often require approval of investors, either by simple majority, unanimous or with qualified majority. The asset manager will need to determine whether rights should be considered merely protective rights, or rights that might give power.

The rights held by others must be considered in context with the other factors, when determining if the asset manager is a principal or an agent.

3.1.3 Remuneration of the asset manager

IFRS 10 provides some guidance on how to evaluate arrangements whereby powers are delegated, including illustrative examples, but does not include any bright lines. If the fee received is commensurate with the services provided, and the arrangement includes 'market' terms, the asset manager is likely

to be considered an agent. However, the greater the fee, and exposure to variability, relative to the expected returns from the investee (the fund), the more likely it is that the asset manager is a principal, and would consolidate the underlying investments.

This will be a challenging area for asset managers in the real estate industry due to the complexity of many fee structures used in the industry. For example, it is common for an asset manager to receive different fees for providing multiple services. In addition, most fee structures are based on variable returns. Studies¹ performed by the European Association for Investors in Non-listed Real Estate Vehicles (INREV) and the Pension Real Estate Association (PREA) in Europe and the US, respectively, showed that most funds charge annual management fees, including acquisition fees, asset management fees, commitment fees, dead deal fees, debt arrangement fees, development fees, disposal fees, fund management fees, performance fees, project management fees and property advisor fees. While not included in the studies, a combination of these fees is also common in Australia. Annual management fees are usually based on the amount of assets under management, but are sometimes also based on gross or net rental income. Performance fees may be based on realised and/or unrealised gains, and may include a hurdle rate. Most hurdle rates are absolute return hurdles, either defined as an internal rate of return (IRR) or total return hurdle. Floating benchmarks are rare, although a few funds in both studies use them together with an absolute return hurdle.

Depending on the magnitude of the percentages above, certain fee structures could lead to the classification of an asset manager as principal, and hence require consolidation of the funds or assets under management. However, the presence of a variable return does not automatically lead to consolidation. An asset manager can receive a variable fee for providing services and still be considered an agent, so it may be difficult to distinguish an agency relationship from that of a principal. An asset manager thus needs to evaluate whether its exposure to variability of returns is different from that of the other investors, and if so, whether this might influence its actions. The right to residual returns, for example, may expose the asset manager to variability of returns from the fund that is different from that of the other investors.

¹ INREV Quarterly Research Report, Issue 4 2010.



3.1.4 Variable returns held through other interests

When an asset manager holds other interests in an investee, which is not uncommon in the real estate industry, this may indicate that it is not an agent. By virtue of holding other interests, decisions made by the asset manager may differ from those it would have made if it did not hold those other interests. For instance, this may be the case when an asset manager provides credit enhancement to the fund, or holds a large direct interest.

In evaluating its exposure to variability of returns from other interests, IFRS 10 requires an asset manager to consider the following:

- (a) The greater the magnitude of, and variability associated with, its economic interests, considering its remuneration (as discussed above) and other interests in aggregate, the more likely the asset manager is a principal
- (b) The more that the asset manager's exposure to variability of returns differs from that of the other investors, the more likely that this might influence its actions, and the more likely that the asset manager is a principal

While this evaluation is made primarily on the basis of returns expected from the activities of the investee, the asset manager must also consider its maximum exposure to variability of returns, taking into account remuneration and other interests that it holds.

When an asset manager therefore holds a direct interest in a fund or is otherwise at risk, e.g., by providing guarantees or credit enhancements, careful evaluation will be needed to determine if that is indicative of the asset manager being a principal or an agent.

How we see it

As described above, in the real estate industry, most fund structures typically comprise an asset management fee and a performance fee upon final exit based on the realised performance over a pre-specified hurdle rate. In most cases, the performance on final exit is dependent on the sales price of the real estate. This makes it difficult to assess which party receives the majority of the expected returns and, hence, the importance the weighting of the variability would be in determining whether an asset manager is an agent or a principal.

Additional complexity exists when remuneration is combined with a direct financial interest or a situation in which the asset manager is otherwise at risk.

Under current IFRS, there is no specific guidance on principal-agency relationships (including consideration of scope of decision-making authority, kick-out rights, remuneration, or other variable interests) or protective rights. IFRS 10 introduces these concepts, but considerable judgement is required as to whether a specific arrangement could lead to consolidation.



3.2 Structured entities (special purpose entities)

For structured entities, which are often used in the real estate and construction industries, the biggest impact from adopting IFRS 10 is likely to be on those that were set up to achieve a desired outcome under SIC 12. In SIC 12, consolidation was required for the entity that had the majority of the risks and rewards. However, many structured entities were set up to remain off the books of the sponsor in situations in which there were no parties that were deemed to have the majority of the risks and rewards.

The changes introduced by IFRS 10 could lead to situations in which consolidation of structured entities is required. The activities that significantly affect the structured entity's returns will need to be determined. The next step is to identify how those activities are directed, that is, what rights give power over those activities. Then, the asset manager needs to identify which entity has the power over those activities. As a result, if an investor has power over the activities that significantly affect returns, and has exposure to variable returns, it would consolidate the structured entity under IFRS 10, even if it does not have a majority of the returns.

3.3 Exception for consolidation of controlled investments by 'investment entities'

The IASB will separately address the issue of whether investment entities (as defined) should consolidate their controlled subsidiaries. An exemption from consolidation is being proposed for investment entities that meet certain criteria related to business purpose, investment activity, exit strategy, unit ownership, pooling of funds, use of fair value for internal and external reporting and whether it is a reporting entity. If finalised, investment entities would be required to measure their controlled investments at fair value through profit or loss.

It is anticipated that the IASB will propose that the consolidation exception would not be available for the parent of an investment entity, unless the parent is an investment entity itself. Therefore, a parent that does not meet the definition of an investment entity would consolidate all controlled investments, including those held by investment entity subsidiaries. If it is determined that an asset manager that is not an investment entity controls and is required to consolidate an investment fund (using the principal-agency guidance discussed above), that manager would consolidate both the fund and the underlying businesses controlled by the fund.

3.4 Summary

For the real estate industry, perhaps the most fundamental changes in IFRS 10 are those dealing with agent and principal considerations. Asset managers must evaluate whether their decision making authority, their exposure to variable returns, the rights held by others, in combination with any other potential interest they hold in the fund under their management, leads to a situation in which they are deemed to have control. This requires a considerable amount of judgement and may lead to situations in which consolidation will be required.



4. Joint arrangements

4.1 Introduction

IFRS 11 describes the accounting for 'joint arrangements' over which two or more parties have joint control. Whereas current IFRS focuses more on the legal form of the arrangement when determining the appropriate accounting, IFRS 11 focuses on the nature of the rights and obligations of the arrangement.

A joint arrangement can be either a joint venture or a joint operation. Joint ventures are to be equity accounted as the IASB eliminated the option of proportionate consolidation. A joint operator will recognise its share of assets, liabilities, revenues and expenses and/or its share of those items, if any.

Whether a joint arrangement is a joint venture or a joint operation requires careful judgement. In addition to considering the rights to assets and obligations for the liabilities of the arrangement, many other factors need to be considered, including, but not limited to, commitments, restrictions, finance guarantees and responsibilities for losses.

How we see it

Care should be taken as to whether under IFRS 11, joint operations and joint ventures are still under joint control. This is because the reference to 'control' in 'joint control' is based on the new definition of control in IFRS 10, which could lead to a different conclusion with respect to whether the arrangement is jointly controlled.

IFRS 11 may have a major impact on the real estate and the construction industries. The main impacts are described below.

4.2 Unit of account

Some contracts may contain more than one joint arrangement. For example, a master agreement that contains the terms and conditions for numerous entities and/or numerous activities may comprise several joint arrangements. This is particularly relevant in the construction industry, where long-term contracts may comprise several joint arrangements, some being classified as joint ventures and some as joint operations. This is in contrast to current IFRS, under which the entire contract would be classified as a joint asset, a joint operation, or a joint venture.

4.3 Joint ventures

There are many types of joint arrangements. Among them are equity-based joint arrangements that benefit foreign and/or local private interests, special interest groups, or members of the public. There are also non-equity joint arrangements, also known as cooperative agreements, in which the parties might seek, for example, technical services, franchise or brand use, management contracts, rental agreements, or one-time construction contracts. Quite often, non-equity joint ventures are used simply to provide access for the participants into foreign markets. Joint venturers will have to consider the facts and circumstances to assess whether these joint arrangements, particularly those that are not equity based, are classified as joint ventures as defined in IFRS 11.

When proportionate consolidation has been used to account for jointly controlled entities under IAS 31, and such entities become classified as joint ventures under IFRS 11, the adoption of IFRS 11 will result in substantial changes to the venturer's financial statements because they will be required to use the equity method.

However, care needs to be taken when classifying a joint arrangement as a joint venture (as opposed to a joint operation), because the definition under IFRS 11 is more one of substance rather than legal form. This is discussed in more detail below.

How we see it

The elimination of proportionate consolidation for joint ventures may be particularly relevant to the real estate industry where, for example, many jointly owned shopping malls are currently treated as jointly controlled entities and proportionally consolidated. IFRS 11 will change this, if such entities are classified as joint ventures going forward.

One of the larger European REITs recently announced that it had voluntarily retrospectively changed its accounting for joint ventures from proportionate consolidation, presumably in anticipation of IFRS 11. It now treats joint ventures as equity accounted investees. This resulted in a lower loan-to-value ratio and lower rental income for that entity. However, management should be cautious when voluntarily changing accounting policies and estimating the impact, since it is possible that arrangements that were previously considered joint ventures under IAS 31 will be considered joint operations under IFRS 11, in which case, the financial impact of adopting IFRS 11 would likely be less significant.



4.4 Joint operations

Jointly controlled assets and jointly controlled operations (as defined under IAS 31), are referred to as joint operations under IFRS 11, and the accounting for those arrangements will be the same as under IAS 31. That is, the entity will continue to recognise its assets, liabilities, revenues and expenses, and/or its relative shares of those items, if any. In addition, some joint arrangements that were previously considered jointly controlled entities might be considered joint operations under IFRS 11. For example, since IFRS 11 considers joint and several liability as an indicator of a joint operation, if an entity previously had a jointly controlled entity that included joint and several liability or guarantees, this arrangement might be classified as a joint operation under IFRS 11.

How we see it

In the construction industry, many joint arrangements are conducted under a general partnership. This is a legal form under which all parties generally are jointly and severally liable for mutual commitments connected with the performance of the project. When determining whether a joint arrangement is a joint operation or a joint venture, joint and several liability and any guarantees issued need to be carefully considered to determine whether they indicate that the parties have rights to the assets and obligations for the liabilities (a joint operation) or rights to the net assets (a joint venture).

4.5 Venture capital organisations and similar entities

Venture capital organisations, mutual funds, unit trusts, and similar entities, including investment-linked insurance funds are still permitted to measure their investments in joint ventures and associates using fair value. However, this may change in the future because of the proposed investment entity scope exception (see Section 3.3). In this project, it is expected that the IASB will propose that only investment entities (as defined) will be required to measure their investments in joint ventures and associates using fair value. This means that venture capital organisations, mutual funds, unit trusts, and similar entities, including investment-linked insurance funds that do not meet the definition of an investment entity would no longer be permitted to measure their investments in joint ventures and associates at fair value, but would instead be required to use the equity method.

4.6 Summary

IFRS 11 classifies a joint arrangement as either a joint operation or a joint venture, based on the contractual rights and obligations of that joint arrangement. This will lead to changes in accounting, either because the accounting has changed or because of changes in classification. Not all arrangements currently classified as joint ventures would also be joint ventures under IFRS 11, but may instead be joint operations. We therefore do expect some fundamental changes for real estate and construction companies.

5. Final thoughts

Within the real estate and construction industries, we expect major accounting changes for real estate asset managers, joint ventures and structured entities. In particular:

- ▶ Management's judgement will be required on additional items that will impact the accounting outcome (as well as on a recurring basis)
- ▶ Thorough analysis of contractual agreements will be needed
- ▶ Robust accounting policies may need to be developed, because of the extent to which judgement is involved
- ▶ Performance metrics and debt covenants may need to be modified
- ▶ System modifications and enhancements may be required to address the change in standards and to provide the necessary information for the new disclosure requirements.



For more information

If you would like to discuss the implications of IFRS 10, 11 and 12 for real estate and construction companies in more detail, or would like our professionals to assist with an initial analysis of the impact on your business, please contact your Ernst & Young representative or any of the following:

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