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MFRS Hot Topics

Accounting for the contribution of assets or businesses to a joint arrangement by a party to the joint arrangement on formation.

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Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This issue specifically provides guidance on accounting that should be applied by the joint arrangement (either a joint operation or joint venture) receiving non-monetary contributions upon its initial formation.

A party may contribute assets or businesses to a joint arrangement in exchange for equity interests (shares where the entity is an incorporated entity) in that entity. The issue is how the joint arrangement (either a joint venture or a joint operation) should record that asset or business.

Specifically, should it record it at its:

- fair value or
- predecessor carrying amount (ie the joint operation or joint venture records the asset or business at the value that it was recorded at in the financial statements of the party making the contribution)?

Contents

Guidance

Accounting for the contribution of an asset or group of assets to the joint arrangement by a joint operator or joint venturer in exchange for equity instruments of the joint arrangement is within the scope of MFRS 2 Share-based Payment and should be accounted for in accordance with the provisions of that standard.

However, there is no specific guidance in MFRS on how the joint arrangement should account for a business contributed by a party to the joint arrangement in exchange for its equity instruments, as such a transaction is scoped out of MFRS 3 Business Combinations (MFRS 3.2(a)) and MFRS 2 (MFRS 2.5). Our view is that MFRS 3, by analogy, can be applied by the joint arrangement, despite the fact that the transaction is outside the mandatory scope of MFRS 3. Alternative approaches may also be acceptable, such as the use of predecessor values or application of fresh start accounting. MFRS 2.5 prohibits the use of MFRS 2. Management should use their judgement and apply the requirements of MFRS 108.10-12 to determine the most appropriate accounting policy to provide relevant and reliable information to users of the financial statements.

Discussion

MFRS 11 Joint Arrangements addresses accounting by the entities that have an interest in arrangements that are controlled jointly (ie joint arrangements). It does not address how the joint arrangement should present its financial statements. Also, MFRS 2 excludes from its scope transactions in which an entity acquires goods as part of net assets acquired in a business combination as defined in MFRS 3, including the contribution of a business on the formation of a joint venture (MFRS 2.5).

(Note that the MFRS 2 scope exemption applies only to the formation of the joint arrangement and so in certain situations, MFRS 2 may be applicable to the joint arrangement's subsequent issuance of equity instruments.)

Consequently, an issue arises when a jointly controlled entity prepares its separate financial statements as to whether it should account for a non-cash contribution received at the book value recorded by the joint venturer or joint operator prior to the transfer (predecessor amount) or at its fair value. The analysis of this issue is simplified if the contribution of an asset and the contribution of a business are considered separately.

Contribution of an asset

A party to a joint arrangement contributes an item of plant, property and equipment to a joint arrangement (eg a joint operation or joint venture as determined in accordance with MFRS 11) upon its formation in return for which it acquires an equity interest in the entity. Should the entity record the asset received at its predecessor amount or at its fair value?

Analysis

MFRS 2.5 states that MFRS 2 shall not be applied to the contribution of a business on the formation of a joint venture. It does not exclude from the scope the contribution of an asset or group of assets that does not constitute a business as defined in MFRS 3. Consequently, measurement of assets contributed in the formation of a joint arrangement should follow the provisions of MFRS 2.10, which states that:

> "for equity-settled share-based payment transactions, the entity shall measure the goods or services received, the corresponding increase in equity, directly, at the fair value of the goods or services, received unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted."

Therefore, the contribution by a party to the joint arrangement of an asset in exchange for shares in the joint venture or joint operation would be measured at the fair value of the goods received, if it can be reliably estimated.

Contribution of a business

The parties to the joint arrangement each contribute a business to the joint operation or joint venture upon its formation in exchange for equity interests in the entity. Should the joint operation or joint venture record the value of the businesses received at their predecessor amounts or at fair value?

Analysis

MFRS 11.34 addresses transactions between a joint operation and a joint operator from the perspective of the joint operator while MFRS 128.30 addresses the contribution of a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, from the perspective of the contributor. IFRS does not address the accounting to be adopted by the joint operation or joint venture itself. Therefore in determining whether the entity should record the asset at its predecessor amount or at its fair value, the requirements of other Standards need to be considered.

Although the transaction in question is a business combination MFRS 3.2 states:

> "This IFRS does not apply to: (a) the formation of a joint venture*".

(Note that this exemption only applies on the formation of a joint arrangement; the acquisition of a business by an existing joint venture or joint operation from a party to that joint arrangement is within the scope of MFRS 3).

The transaction is therefore outside the scope of MFRS 3. Also, MFRS 2.5 specifically provides that MFRS 2 shall not be applied to this type of transaction. In the absence of any other guidance in MFRS, entities should apply the requirements of MFRS 108.10-12 to develop an appropriate accounting policy. In our view, an appropriate outcome of this analysis is to apply MFRS 3 by analogy.

However, other accounting policies could also be appropriate. One possible approach is to record the assets using predecessor values (similar to an approach often applied in accounting for common control business combinations). Another approach that is sometimes advocated is referred to as 'fresh start accounting'. This method is not specified in MFRS but is applied to some transactions under other national accounting frameworks. Broadly, this method assumes that neither business contributed by the joint operators or joint venturers survives as an independent reporting entity after the formation of the joint operation or joint venture. Instead, a new reporting entity with no reported 'history' is created, starting with the formation of the joint arrangement, with assets acquired and liabilities assumed recognised at their fair values on the formation date. There are diverse views in the application of the fresh start accounting method where one view suggests recognition of goodwill while in another view, goodwill is not recognised.

Management should use their judgement to determine the accounting policy choice that would provide the most reliable information. The approach adopted should be explained in an accounting policy note together with the judgements that management has made in selecting such a policy (Paragraph 122 of MFRS 101 First-time Adoption of MFRS).

Example
Contribution of a business by a joint venturer on formation of the joint venture

Two venturers each contribute a business to an entity upon its initial formation. The book value of each business contributed is CU100 (representing solely tangible assets) and the fair value of each business as a whole is CU200. The fair values of separately identifiable assets and liabilities of each business are: property, plant and equipment of CU110, intangible assets of CU60, and a deferred tax liability of CU10.

How should the joint venture record the contributions it has received?

If predecessor accounting is used, the tangible assets of CU200 can be recognised at their previous book values.

If fresh start accounting is used, then tangible assets of CU220, intangible assets of CU120 and a deferred tax liability of CU20 can be recognised. The difference of CU80 may or may not be recognised as goodwill depending on the accounting policy used in applying fresh start accounting.

If IFRS 3 is applied by analogy, one of the combining entities will be recognised as the accounting acquirer (MFRS 3.B18). Consequently, its assets and liabilities will continue to be recognised at predecessor values (tangible assets of CU100) and the other, accounting acquiree, will be measured at fair value. Consequently, property, plant and equipment of CU210 (100 + 110), intangible assets of CU60 (nil + 60), a deferred tax liability of CU10 (nil + 10) and goodwill of CU40 (200 - 110 - 60 + 10) should be recognised.

KUALA LUMPUR

Level 11, Sheraton Imperial Court
Jalan Sultan Ismail
50774 Kuala Lumpur

T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

PENANG

51-8-A,
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang

T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

KUANTAN

A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang

T +609 515 6124
F +609 515 6126
E info.ktn@my.gt.com

JOHOR BAHRU

Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor

T +607 223 1848
F +607 224 9848
E info.jb@my.gt.com

www.gt.com.my