Wake Up Call

Alignment of business & financial reporting strategy

Our company have lots of land to be developed. We plan to invite partners to establish a joint operation, that is to maximize the value of assets. Is it true that joint operation schemes have impact to financial statements, can you provide more information on this?

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There are several ways in maximizing the value the assets trough cooperation with other parties. The most common is by establishing a new entity, where one party controls this new entity, and other parties contributes their portion. Alternatively, by sharing the control between parties involved, either by forming a new company or not. The decision shall be based on several considerations, such as legal, technology, expertise, taxation and the company's strategy. How to record in the financial statements will then depend on the nature and substance of the cooperation.

When the parties consider that the establishment of a new entity in which one party will control and the others only take part as sleeping partners, consolidation approach is applied. By this approach, the controlling entity will record all assets, liabilities, revenues and expenses of this new entity. As a consequence, the financial performance of the cooperation will be fully reflected in the financial statements of the controlling entity.

Another choice is the sharing of controls among parties, known as joint control. In joint control arrangement, the parties shall have a contractual agreement, stated that they agree to share controls in which decisions about the relevant activities (that is strategic financial and operating decisions) require unanimous consent of the parties sharing controls. In this joint arrangement (JA), it decided when does activities of selling and purchasing of goods or services, managing financial assets during their life, selecting, acquiring or disposing of assets, researching and developing new products or processes, and determining funding structure- require unanimous consent of the parties that control collectively. There are 2 types of JA, joint operation and joint venture.

A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators. Joint operator shall recognize in relation to its interest in a joint operation: its assets, including its share of any assets held jointly; its liabilities, including its share of any liabilities incurred jointly; its revenue from sale of its share of the output arising from the joint operation; its share of the revenue from the sale of the output by the joint operation; and its expenses, including its share of any expenses incurred jointly. Therefore, the financial performance of the joint operation is not fully reflected in controller's financial statements.

A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers. Joint venturers (JVs) recognize its interest in a joint venture as an investment and account for that investment using the equity method, meaning that JV's interest is initially recognized at cost and the carrying amount is increased or decreased to recognize the JV's share of the profit or loss of the joint venture after the date of establishment. As a result, financial performance of JV is reflected in 1 line item in the JVs profit or loss.

In sum, there are three options on how a business cooperation impact the financial performance. First,joint arrangement's financial performance is fully reflected. Revenue, expenses and profit of the cooperation are included in revenue, expenses and profit of the company. Second, join arrangement's financial performance is reflected to the extent the company's interest. Revenue, expenses and profit of the cooperation are recognized in the revenue, expenses and profit of the company at the amount equal to its interest. Third, joint arrangement's financial performance is reflected in one item in profit or loss.

When your business strategy emphasizes on revenue and asset growth, the first and second may be more preferable. If it emphasizes on return on assets, the third is preferable as it creates less asset with similar amount of profit. Do not forget that nature of control be the primary driver in determining the appropriate accounting treatment.

KEY POINTS

- Company may maximize its asset value through cooperation with other party
- There are implications on accounting a joint arrangement, which treatment are depending on the cooperation strategy opted by company
- One consideration in determining accounting treatment is the measures used in business development strategy

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