A spotlight on transport

Profit margin is a measure used to define job effectiveness. Third party logistics (3PL) companies remain relevant and competitive by being cost effective. Longer route times, trickier cargo and an increase in customer demand around time and cost have driven the need for 3PL companies to collaborate for effective solutions.

Over the years, I have worked with a number of transport and logistics companies both as a consultant and an audit and assurance professional. A common conversation when discussing growth and future prospects within the industry, centres around understanding the importance of business arrangements and relationships. This understanding has been crucial to the way the industry has adapted in the past, and is the key to staying on top of 21st century challenges.

In this article I explore the impact business arrangements, service agreements and strategic partnerships have on financial statement accounting and presentation of 3PL companies.

Understanding the importance of business arrangements

In New Zealand (NZ) the 2014 market sectors report issued by the Ministry of Business Innovation and Employment (MBIE) reported that travel and logistics contributed over $11 billion to the NZ economy and within this amount that 3PL companies contributed $2.6B (These numbers are not totally unexpected when you consider the level of import/export trade activity NZ business is conducting).

The transport and logistics industry (the industry) has continued to grow with an increase in the number of service providers offering various modes of transport and/or services to meet growing customer demand. This growth supplements the growing appetite of businesses within the industry for better leaner supply chain management as a key ingredient for competitive advantage.

Why should business arrangements be considered?

Most companies are deterred from making wholesale changes to current service offerings due to the significant cost involved. The availability of a reasonable alternative will be much more effective in terms of cost and client service. Management are aware of the importance of creating strong strategic partnerships not only with other market suppliers but also with trusted individuals who will not damage and/or disrupt your own customer relationship. Companies will often field calls from key customers asking whether a specific service option is available or whether you can get cargo to a different destination. Good companies will keep customers by communicating with other suppliers to fulfil customer service requirements. Great companies will formalise longer service agreements to provide security and assurance over supply.

Becoming increasingly apparent is the impact these agreements can have on a company's financial statements. For accounting purposes, business relationships often produce 'unintended consequences' where agreements are entered as one arrangement however are treated as something different. A classic example would be a company entering into a joint venture or an 'associate' arrangement and being treated similar to an investment in a subsidiary as one party is deemed to have 'control'.

How do you distinguish what is what?

For accounting purposes, identification of 'what is what' is based on the terms and conditions of the agreement. Accordingly it is important to consider the designation of a business arrangement whilst you are drafting up and negotiating terms of the relationship i.e. contractual agreement stage. As a simple reminder here are some common arrangements and key attributes are detailed in the below table:

Arrangement	Key attributes	Accounting

Investment	- An equity interest of less than 20% - No board representation - No influence over management decisions and activities	Initially measured at cost, subsequently measured at 'fair value'
Investment in an associate	- Equity interest of between 20% - 49% - Can have board representation - Influence but no control over management decisions & activities	Initially measured at cost, subsequently measured using equity accounting
Joint arrangement / joint venture	- Two or more parties have joint control i.e. no one party can control - Bound by contractual agreement - Management decisions require unanimous consent	Initially measured at cost, subsequently measured using equity accounting/ proportionate consolidation – this will depend on type.
Subsidiary	- Investor has control - Overriding vote over management decision & activities - Power over benefits	Fully consolidated

The table above is indicative only as business arrangements become increasingly complex. The key point to note is that the accounting for each can be significantly different. Although the applicable accounting standards were issued in 2011, I have seen recent examples of incorrect initial assessments. Much of these initial errors came down to a greater number of factors needing to be considered outside of pure equity interest.

What could go wrong?

The impact of getting the above wrong could have the unintended consequence of moving from one accounting treatment to another; such as moving from accounting for an investment in associate ('equity accounting') through to fully consolidating the results of another entity. The impact could have a significant impact on your reportable results for the period. The introduction of *NZIFRS 10: Consolidated financial statements* and *NZIFRS 11: Joint arrangements* in 2011 has established more defined rules of what to look for when considering business arrangements. Voting interest on its own is no longer the determining factor as these standards add more considerations such as the concepts of 'control' and 'benefit' when determining whether an entity is controlled by another entity or not.

What to look out for?

I know it is a cliché however 'the devil is in the detail'. Getting the experts in will ensure your legal treatment is on par with your accounting treatment. Although not an exhaustive list here are some common features of contracts I have seen which can cause some tricky interpretations.

Key term	What does this mean and what could be the outcome
Protective rights	Commonly included in agreements to protect the rights of smaller counter parties. Effectively stops significant decisions from occurring i.e. shutdown of operations. In Joint arrangements such as a joint venture, protective rights may mean that the concept of joint control is not present. Consequently, giving one party control and the need to consolidate.
Management control	Some agreements are structured that one party may have a smaller equity interest however it may explicitly give that party full decision making power and management control of the relevant activity. Generally speaking, if you have management control you are also likely to have control.
Overriding votes	Some agreements give one party the ability to be the decision maker. Those that do are likely to have 'control' and should be treated as a subsidiary and fully consolidated.
Establishing New Co's or no 'vehicle' at all	Common practice is to establish a 'New Co' where interests within this new entity are split. Understanding the role of the New Co is important as it will have a direct impact on the accounting treatment. Not having a vehicle in a joint arrangement is common

	and may change the accounting treatment from a joint venture to a joint operation.
The lack of an agreement	Formalising business arrangements via a legal agreement is a business practice that should always be followed. Lack thereof may open up arrangements to judgement.

RSM and how we can help you

RSM is a leading middle market specialist with a focus on transport and logistics. Globally and in New Zealand we act for a number of different transport and logistics companies who operate in the Asia Pacific region. Transport and logistics is an industry focus of our firm and this article kicks off the first of a series which will look specifically at accounting and business issues faced by the industry. The industry is primed for growth as export and import activity continues to provide strong contribution to the NZ economy.

For an industry that is based on job margin and job profit, avoid setbacks and unintended consequences by reviewing and assessing key agreements before putting pen to paper. With our dedicated technical desk and our industry experience we are well placed to provide you the assistance you require.

If you would like to discuss how we can help please contact us.

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