Accounting for collaborations in the life sciences sector

Challenges in applying IFRS 10 and IFRS 11

June 2013
Introduction

Life sciences entities commonly enter into collaborative research arrangements. Such arrangements can take many forms ranging from funding research and development activity to mutual research and development collaborations, as well as investments in smaller specialised entities. For example, a collaboration could involve a biotech entity granting a pharmaceutical entity the commercialisation rights for a product candidate in exchange for (a) an upfront payment, (b) ongoing payments for research and development services, (c) future payments contingent upon the achievement of specified milestones, and (d) royalties on commercial sales.

When accounting for collaboration arrangements it may be challenging to determine whether the pharmaceutical entity should consolidate the biotech entity, treat the collaboration as a joint arrangement, or account for the acquisition of intangible and other assets. This publication is intended to assist life sciences entities to understand the implications of the new accounting standards for consolidation (IFRS 10 Consolidated Financial Statements) and joint arrangements (IFRS 11 Joint Arrangements) on collaboration arrangements.

These new standards change the definitions of control and joint control. While the method used to consolidate an entity has not changed, investors could be consolidating different entities under IFRS 10. Furthermore, IFRS 11 will change the categorisation of joint arrangements and may change the method of accounting for these arrangements. Even if collaborations currently accounted for as joint arrangements meet the new definition of joint control, the accounting requirements could change. Investors will be required to carefully and continuously assess the structure and legal form of collaboration arrangements, the contractual terms and conditions agreed to by the parties to the arrangement and other facts and circumstances.

What’s the impact?

- Terminology has changed as a result of the new standards. Some terms will be familiar, but may have a different meaning.
- Both IFRS 10 and IFRS 11 require a continuous assessment of whether an investor has control or joint control of an investee.
- IFRS 10 requires a qualitative analysis to determine who has control. Investors will need to carefully assess whether some of their research and development collaboration arrangements or research and development financing structures need to be consolidated.
- IFRS 11 classifies joint arrangements as either joint operations or joint ventures. Proportionate consolidation of jointly controlled entities is no longer permitted under IFRS 11. Jointly controlled entities may now be classified as joint ventures under IFRS 11 and will have to be accounted for using the equity method. Conversely, some jointly controlled entities that are currently accounted for using the equity method may now be classified as joint operations. Joint operation accounting will require an investor to recognise its relative share of the assets, liabilities, revenues and expenses of the joint operation in a manner similar to, although not the same as, proportionate consolidation.
- Adopting IFRS 10 and IFRS 11 could impact the presentation of financial statements. In some instances, there may be measurement differences that could affect profit or loss.
- Accounting and consolidation systems, business processes and controls may need to be updated, and there may be impacts on other areas of the business, such as covenants, remuneration structures, etc.
- IFRS 12 Disclosure of Interests in Other Entities requires enhanced disclosure of an entity’s involvement with other entities that it controls or jointly controls.
- Certain differences between the generally accepted accounting principles in the United States (US GAAP) and International Financial Reporting Standards (IFRS) remain.
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What you need to know

- The International Accounting Standards Board (IASB) issued three new standards and amended two existing standards (IAS 27 Separate Financial Statements (as revised in 2011) and IAS 28 Investments in Associates and Joint Ventures (as revised in 2011)) to form a complete set of standards to account for subsidiaries, associates and joint arrangements:
  - IFRS 10 – includes a new definition of control and introduces additional requirements that could impact any previous assessment of control
  - IFRS 11 – defines joint control, classifies joint arrangements into two types and describes the accounting for these arrangements. Proportionate consolidation is no longer permitted for any type of joint arrangement
  - IFRS 12 – requires new and expanded disclosures for joint arrangements, as well as for subsidiaries, associates and structured entities, which will impact processes and systems
- These new standards are effective for annual periods beginning on or after 1 January 2013 and must be applied retrospectively. Early adoption is permitted provided that an entity applies IFRS 10, IFRS 11, IFRS 12, IAS 27 and IAS 28 at the same time.
- Significantly more judgement is required to apply the new standards.

For a more complete summary of these new standards and the impacts on your business, refer to our general publications:

- Applying IFRS: Challenges in adopting and applying IFRS 10 (September 2011) (General IFRS 10 publication)
- Applying IFRS: Challenges in adopting and applying IFRS 11 (September 2011) (General IFRS 11 publication)
- IFRS Developments, Issue 35: Transition guidance amendments for IFRS 10, IFRS 11 and IFRS 12 (July 2012)

This is a life sciences sector-specific supplement to the general publications listed above. This supplement focuses on some of the implications of IFRS 10 and IFRS 11 that are specific to the life sciences sector. These and other publications are available at www.ey.com/IFRS
1. Which standards apply to collaboration arrangements?

Collaboration arrangements can take many forms. Therefore, when assessing the interaction between the partners in a collaboration (collaborators) and between collaborators and the collaboration arrangement (whether it is a separate entity or not), it is important to understand which standards should be considered. The appropriate standard(s) to apply will depend on the specific facts and circumstances.

As Diagram 1 outlines, if a life sciences entity controls the collaboration arrangement that is a separate entity, it would consolidate that entity in accordance with IFRS 10. IFRS 11 would apply if a life sciences entity jointly controls the collaboration arrangement (which may or may not be in a separate legal entity). Collaborators may also need to consider whether they control another entity (e.g., another collaborator) through the arrangement.

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Diagram 1 — Interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28

1 This would be the case, for example, if an entity has control over (or simply rights to) assets and obligations for liabilities, but not control of an entity. In this case, the entity would account for these assets and obligations in accordance with the relevant IFRS.
If the life sciences entity does not control the collaboration arrangement and does not have joint control, it will need to account for:

a) Its associate in accordance with IAS 28, if the entity has significant influence over its investment

b) Its interests in specific assets and liabilities in accordance with the relevant IFRS, e.g., IAS 16 Property, Plant and Equipment, IAS 38 Intangible Assets or IAS 37 Liabilities, Contingent Liabilities and Contingent Assets

Or

c) Its financial instrument(s) in accordance with IAS 39 Financial Instruments: Recognition and Measurement or IFRS 9 Financial Instruments

2. The concept of control in IFRS 10

IFRS 10 establishes a single control model that applies to all entities, including ‘special purpose entities’ (i.e., ‘structured entities’ and ‘variable interest entities’ under the new standards and US GAAP, respectively). Management will be required to exercise significant judgement in order to determine which entities are controlled (i.e., the collaboration arrangement itself or another entity controlled through the arrangement). IFRS 10 changes the assessment of whether an entity is to be consolidated by revising the definition of control and adding requirements to consider when making decisions about control.

IFRS 10 states that “an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee”. Therefore, a life sciences entity (the investor) controls a collaboration arrangement or, through the arrangement, another entity (the investee) if, and only if, the life sciences entity has all of the following:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee
- The ability to use its power over the investee to affect the amount of its returns

Understanding the purpose and design of an arrangement is critical when identifying whether these elements exist. An investor must continuously reassess control if there are changes to one or more of the three elements of control.

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2 IFRS 10.6
3 IFRS 10.7
Diagram 2 highlights factors to consider when assessing control. Importantly, although ownership of a debt or equity interest may be a key factor in determining whether a life sciences entity has control, it is also possible for a party to a collaboration arrangement to be an investor and potentially control an investee without having any equity or debt interest.

In order to understand the purpose and design of an arrangement, it may be helpful to consider factors such as:

- To which risks was the investee designed to be exposed and which risks were designed to be passed on to the investors or other parties with which the investee is involved?
- What are the relevant activities?
- How are decisions about the relevant activities made?
- Who has the ability to direct the relevant activities?
- Which parties have exposure to variable returns from the investee?
- How do the relevant activities affect returns?
- Do the parties that have power and exposure to variable returns have the ability to use that power to affect returns?

Below, we consider some of the key factors for life sciences entities to consider when assessing whether control exists. Chapters 3–5 of our General IFRS 10 publication include more extensive guidance on assessing control.

How we see it

The control assessment under IFRS 10 is broader and requires more judgement to be applied than the assessment under IAS 27. Adopting IFRS 10 could result in some collaboration arrangements that are currently treated as joint arrangements being consolidated as subsidiaries (i.e., consolidated). In addition, depending on the specific facts and circumstances, different investors may control a collaboration arrangement at different stages of the arrangement. Correctly understanding the purpose and design of collaboration arrangements will, therefore, be critical.
2.1 Power over an investee

The first requirement for control relates to power. A life sciences entity will have power over an investee when it has existing rights that give it the current ability to direct the relevant activities. This requires that a life sciences entity determine:

- The relevant activities
- Its existing rights

2.1.1 Relevant activities

Relevant activities are the activities of the investee that significantly affect the investee’s returns (i.e., the returns to which an investor is entitled). Identifying the relevant activities is a crucial step in assessing control. Examples of relevant activities include:

- Determining or changing operating and financing policies (which might include the items below)
- Determining research and development plans for product candidates
- Appointing, remunerating or terminating service providers, including clinical research organisations and contract manufacturers
- Appointing, remunerating or terminating key management personnel
- Purchasing raw materials and services
- Commercialisation, marketing and selling of product candidates products and services
- Selecting, acquiring or disposing of assets
- Researching and developing new product candidates or processes
- Developing and producing active ingredients
- Making capital or funding decisions
- Establishing budgets
- Managing financial assets during their life (and/or upon default)

When there is more than one activity that significantly affects an investee’s returns (i.e., the relevant activities), and these activities are directed by different investors, it is important to determine which of the activities most significantly affect the investee’s returns. For example, one activity might be directed by voting rights, which are held by one investor, while another activity might be directed through a contract with different investors. This is illustrated in the following example, which is taken from IFRS 10.
Example 1 — Identifying relevant activities in life sciences collaboration arrangements

Two investors form an investee to develop and market a medical product. One investor is responsible for developing and obtaining regulatory approval of the medical product — that responsibility includes having the unilateral ability to make all decisions relating to the development of the product and to obtaining regulatory approval. Once the regulator has approved the product, the other investor will manufacture and market it — this investor has the unilateral ability to make all decisions about the manufacture and marketing of the project. If all the activities — developing and obtaining regulatory approval as well as manufacturing and marketing of the medical product — are relevant activities, each investor needs to determine whether it is able to direct the activities that most significantly affect the investee’s returns. Accordingly, each investor needs to consider whether developing and obtaining regulatory approval or the manufacturing and marketing of the medical product is the activity that most significantly affects the investee’s returns and whether it is able to direct that activity. In determining which investor has power, the investors would consider:

a) The purpose and design of the investee
b) The factors that determine the profit margin, revenue and value of the investee as well as the value of the medical product
c) The effect on the investee’s returns resulting from each investor’s decision-making authority with respect to the factors in (b); and
d) The investors’ exposure to variability of returns.

In this particular example, the investors would also consider:
e) The uncertainty of, and effort required in, obtaining regulatory approval (considering the investor’s record of successfully developing and obtaining regulatory approval of medical products); and
f) Which investor controls the medical product once the development phase is successful.

IFRS 10 is not specific in terms of which of the activities in Example 1 above would be deemed the most relevant activity. If the most relevant activity was developing and obtaining regulatory approval of the medical product, the investor that has the power to direct that activity would have power from the date of entering into the collaboration arrangement. However, if the most relevant activity was the manufacturing and marketing of the medical product, the investor that has the power to direct that activity would have power from the date of entering into the collaboration arrangement. The concept of joint control is discussed further in Section 3 below.

Since collaboration arrangements in the life sciences sector often involve activities that are subject to change, it is important to understand whether such a change might require an entity to reassess whether it has control. In our view, changes that are pre-determined, typically at the inception of a collaboration arrangement, would not result in a reassessment. Judgement will be needed to carefully assess any changes in facts and circumstances.

Take Example 1 above: the relevant activities might take place at different times or stages during a collaboration arrangement. The development and regulatory approval of a new drug must take place first, followed by the marketing and distribution activities. Moving from the one activity to the other is pre-determined. That is, the timing and nature of the activities, including any inherent uncertainty associated with the relevant activities, is part of the original purpose and design of the collaboration arrangement. The fact that these activities might take place at different times, may not, in our view, lead to a reassessment of control.

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4 IFRS 13.B13
A change in facts and/or circumstances that is not pre-determined may lead to a reassessment. For example, assume that after obtaining regulatory approval for the medical product, the parties to the collaboration arrangement in Example 1 elect not to market and sell it directly, but rather to out-license those activities. In that situation, the purpose and design of the collaboration arrangement would have changed from the original agreement, which could require management to reassess control. An investor must reassess control if there are one or more changes to the three elements of control.

2.1.2 Existing rights
As is discussed in Section 2.1 above, once the relevant activities are identified, the next step is to determine which investor, if any, has the ‘current ability’ to direct those activities. Sometimes, assessing power is straightforward, such as when power over an investee is obtained directly and solely from the voting rights that stem from holding voting interests (e.g., shares) and can be assessed by considering the voting rights from those shareholdings. In other cases, the assessment is more complex and requires many factors to be considered (e.g., instances when power is embedded in one or more contractual arrangements, such as research and development and management contracts). However, ‘current ability’ does not always mean ‘able to be exercised this instant’. These concepts are discussed in more detail in Chapter 3 of our General IFRS 10 publication.

Evaluating whether rights are substantive
For a right to give power, it cannot merely be a protective right. A protective right is one that is designed to protect the interest of the party holding it, but without giving that party power over the entity to which those rights relate. In addition, the right must be a substantive right, which means the holder must have the practical ability to exercise the right). Whether rights are substantive depends on facts and circumstances. Chapter 3 of our General IFRS 10 publication discusses examples of rights that can give an investor power, such as those outlined in the extract from IFRS 10.B15 below. Note that these examples are indicative, not determinative. All facts and circumstances of a collaboration arrangement would need to be assessed before concluding.

### Extract from IFRS 10

B15. Examples of rights that, either individually or in combination, can give an investor power include but are not limited to:

a) rights in the form of voting rights (or potential voting rights) of an investee;

b) rights to appoint, reassign or remove members of an investee’s key management personnel who have the ability to direct the relevant activities;

c) rights to appoint or remove another entity that directs the relevant activities;

d) rights to direct the investee to enter into, or veto any changes to, transactions for the benefit of the investor; and 

e) other rights (such as decision-making rights specified in a management contract) that give the holder the ability to direct the relevant activities.
Power without a majority of voting rights (de facto control)

In some cases, an investor may have control over an investee even when it has less than a majority of the voting rights of that investee. This is known as ‘de facto control’. IFRS 10.B42 provides the following guidance to help investors assess their voting rights. However, there are no bright lines. As such, applying this concept will require significant use of judgement of all the facts and circumstances. Chapter 3 of our General IFRS 10 publication provides some examples illustrating how to assess whether an investor has power when it has less than a majority of voting rights.

Extract from IFRS 10

B42. When assessing whether an investor’s voting rights are sufficient to give it power, an investor considers all facts and circumstances, including:

a) The size of the investor’s holding of voting rights relative to the size and dispersion of holdings of the other vote holders, noting that:

(i) the more voting rights an investor holds, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

(ii) the more voting rights an investor holds relative to other vote holders, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

(iii) the more parties that would need to act together to outvote the investor, the more likely the investor is to have existing rights that give it the current ability to direct the relevant activities;

b) Potential voting rights held by the investor, other vote holders or other parties;

c) Rights arising from other contractual arrangements; and

d) Any additional facts and circumstances that indicate the investor has, or does not have, the current ability to direct the relevant activities at the time that decisions need to be made, including voting patterns at previous shareholders’ meetings.

Potential voting rights

Potential voting rights and the existence of contractual arrangements are often seen in collaboration arrangements in the life sciences sector. Typical examples of potential voting rights include options, forward contracts and conversion features of a convertible instrument. When assessing whether it has power over an investee, a life sciences entity should consider the potential voting rights that it holds, as well as potential voting rights held by others.

Options are one type of potential voting right typically seen in collaboration arrangements. If an investor has less than a majority of voting rights, but holds a substantive option that, if exercised, would give the investor a majority of voting rights, that investor would likely have power. The opposite is also true. If an investor holds a majority of the voting rights, but those voting rights are subject to a substantive option held by another investor, the majority shareholder would likely not have power. Example 2 illustrates such a situation.
Example 2 – Potential voting rights

Pharma has entered into an arrangement with Biotech, an independent and financially robust third party, to develop an existing compound owned by Pharma, on Pharma’s behalf.

Pharma does not participate directly in the development of the compound and does not participate in the funding of the development. However, in the case of successful completion of the development as evidenced by final submission of relevant documents for regulatory approval in the key markets, Pharma has the option to buy back the right of commercialisation of the compound. Pharma holds 40% of the voting rights of Biotech, and holds a currently exercisable in-the-money option to acquire a further 20% of the voting rights of Biotech.

Assuming that voting rights give power over Biotech, that the option is substantive and that no other facts and circumstances are relevant to this assessment, Pharma would likely have power over Biotech, because Pharma can exercise its right at any time to obtain a majority of Biotech’s voting shares.

Although IFRS 10 is silent on whether the intention of the holder to exercise the option should be considered, IFRS 10 is clear that an option is only considered in the assessment of power if it is substantive (i.e., the holder has the practical ability to exercise the option). The assessment of whether an option is substantive depends on facts and circumstances. Typical factors to consider when evaluating whether an option is substantive include:

- The exercise price or conversion price, relative to market terms
- The holder’s ability to obtain financing
- The timing and length of the exercise period
Diagram 3 further illustrates these factors and their impact on the conclusion of whether the potential voting rights are substantive. The assessment of whether a potential voting right is substantive involves significant judgement and may require entities to implement processes to monitor these factors. For example, a change in the share price of an investee may result in an option changing from ‘out-of-the-money’ to ‘in-the-money’. More facts would be needed to assess whether the option is substantive. For example, when are the relevant activities expected to take place? When could the options be exercised? Would the investor have or be able to obtain sufficient funds to exercise the option? Chapter 3 of our General IFRS 10 Publication discusses these concepts further.

Diagram 3 – Evaluating whether potential voting rights are substantive

IFRS 10’s guidance on potential voting rights could have a significant impact for some life sciences entities because options to acquire individual assets, parts of businesses, or entities as a whole have become increasingly popular in the life sciences sector in recent years.

In situations where potential voting rights could affect the assessment of control, a careful assessment of all facts and circumstances will be needed. In particular, it may be practically difficult to determine at what date potential voting rights become substantive and, therefore, when control is obtained (the potential impact on accounting for subsidiaries under IFRS 10 is discussed in Section 3 below).

It should be noted that the IASB considered, but did not change, similar requirements in IAS 28 related to how options are considered when evaluating whether an investor has significant influence. IAS 28 does not incorporate the IFRS 10 concept of evaluating whether an option is substantive for investments in associates. Accordingly, an option may give power under IFRS 10, but the same option might not result in significant influence under IAS 28.

Rights from contractual arrangements (including structured entities)

For some collaboration arrangements, the relevant activities are not directed through voting rights, but rather are directed by other means, such as through a contract. For example, an investor may have the contractual ability to direct research and development processes, operating activities, or determine financing of an investee through a contract or other arrangement.

When identifying which investor, if any, has power over an investee, it is important to review the contractual arrangements that the investor and the investee entered into. This analysis should include the original formation documents and governance documents of the investee, as well as the marketing materials provided to investors and all other contractual arrangements entered into by the investee.
In the life sciences sector it is typical for the relevant activities of an investee to be directed by contractual arrangement. This may include establishing the investee as a structured entity. IFRS 10 and IFRS 12 carry forward the concept of a ‘special purpose entity’ – now called a ‘structured entity’ – from SIC-12 Consolidation – Special Purpose Entities. However, SIC-12 was withdrawn when IFRS 10 was issued.

As defined in IFRS 12, a structured entity is one that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements. Therefore, an entity that is controlled by voting rights is not a structured entity.

Management needs to evaluate whether it controls a structured entity using the same approach as for traditional entities (those that are controlled through voting rights). This means that management will need to evaluate whether an investor has power over the relevant activities, exposure to variable returns and the ability to affect those returns through its power over the structured entity.

A structured entity will have some or all of the following features:

- Restricted activities
- A narrow and well-defined objective, such as:
  - Carrying out research and development activities
  - Funding an entity
  - Providing investment opportunities for investors by passing on risks and rewards associated with assets to investors
- Insufficient equity to finance its activities without subordinated financial support
- Financing in the form of multiple contractually-linked instruments to investors that create concentrations of credit or other risks (tranches)

**Example 3 — Structured entities**

Pharma Co, which conducts research and development activities, has a product candidate in clinical trials. To finance the clinical development of the product, Pharma Co enters into agreements with an investor (Finance Co) and Finance Co’s wholly-owned subsidiary created for this financing transaction, a research and development special-purpose entity (R&D Co).

Finance Co’s investors contribute C$50 million to Finance Co in exchange for 100% of Finance Co’s voting equity. Finance Co simultaneously contributes the cash to R&D Co in exchange for all of R&D Co’s equity.

Pharma Co grants R&D Co access to its product candidate. The agreement gives Pharma Co and Finance Co equal representation on a joint steering committee that will oversee the development of the product candidate. The joint steering committee prepares the development plan and budget for the product candidate. The charter agreement of the joint steering committee includes a dispute resolution provision, which states that Pharma Co makes the final decision in relation to the research and development activities of R&D Co in the event that the joint steering committee cannot reach a consensus.

Example 3 shows that, despite the fact that Finance Co holds all of R&D Co’s equity and Pharma Co and Finance Co have equal representation on the joint steering committee, the charter agreement of the joint steering committee may enable Pharma Co to direct the research and development activities of R&D Co, the structured entity. Therefore, Pharma Co has the final decision in the event of a dispute. If it is concluded that these research and development activities are the activities that most significantly affect the returns to investors, Pharma Co would have power over R&D Co.
2.1.3 Other evidence of power
It may be difficult, in some situations, to determine whether an investor’s rights give it power over a collaboration arrangement. In such cases, the investor would consider other evidence that it has the current ability to direct the collaboration arrangement’s relevant activities. For example, the investor may have evidence that it has the practical ability to:

- Appoint, approve or nominate the collaboration arrangement’s key management personnel (or Board of Directors)
- Direct the collaboration arrangement to enter into, or veto any changes to, significant transactions that affect the investor’s exposure to variable returns
- Dominate either the nominations process for electing members of the collaboration arrangement’s governing body, or obtaining proxies from other holders of voting rights

If the investor is a related party of the majority of the members of the investee’s governing body or of its key management personnel, that may also provide evidence that the investor has power over the investee.

Other factors might also indicate that an investor has power over an investee. For example, IFRS 10 states that this might be the case when the investee:

- Is directed by key management personnel who are current or previous employees of the investor
- Has significant obligations that are guaranteed by the investor
- Has significant activities that either involve or are conducted on behalf of the investor
- Depends on the investor for:
  - Funding a significant portion of its operations
  - Licences, trademarks, services, technology, supplies or raw materials that are critical to the licensee’s operations
  - Key management personnel, such as when the investor’s personnel have specialised knowledge of the investee’s operations

Example 4 — Structured entities and other evidence of power
Assume the same facts as in Example 3, except that the joint steering committee charter agreement’s dispute resolution provision specifies that the board of directors of R&D Co makes the final decision in the event that the joint steering committee cannot reach consensus. Further assume that the board of directors of R&D Co is composed of two representatives of Pharma Co and three representatives of Finance Co.

In this scenario, Finance Co has 100% of R&D Co’s voting equity and is able to appoint the majority of R&D Co’s directors. Therefore, Finance Co has the current ability to direct the relevant activities of R&D Co.
2.2 Exposure to variable returns

The second criterion for assessing whether an investor has control of an investee is determining whether the investor has exposure (or rights) to variable returns from its involvement with the investee. Returns can be positive, negative, or both.

Examples of exposures to variable returns include:

- Returns from potential commercialisation of a product
- Returns from the development and sale of an asset
- Dividends, fixed interest on debt securities that expose the investor to the credit risk of the issuer, variable interest on debt securities, other distributions of economic benefits and changes in the value of an investment in an investee
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, residual interests in the investee's assets and liabilities on liquidation of that investee, tax benefits and access to liquidity that an investor has from its involvement with the investee
- Economies of scale, cost savings, scarce products, proprietary knowledge, synergies, or other exposures to variable returns that are not available to other investors

When IFRS 10 discusses an investor's exposure to variable returns, it generally focuses on the returns that are generated by the investee. However, depending on the purpose and design of the collaboration arrangement, when the investor receives returns that are not generated by the investee, but which stem from involvement with the collaboration arrangement, these returns are also considered. For example, if an investor were to achieve economies of scale or synergies by combining the research or commercialisation operations or assets of the investee with its own research or commercialisation operations or assets, this would give the investor an exposure to a variable return. Such synergies may be difficult to measure or quantify. However, they are still part of the qualitative assessment of control. Table 1 highlights arrangements in the life sciences sector and provides examples of possible exposures to variable returns. See Chapter 4 of our General IFRS 10 publication for further discussion.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Examples of exposures to variable returns</th>
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<tbody>
<tr>
<td>One entity holding equity interests of another entity</td>
<td>Exposure to changes in the value of the investment (including equity price risk for traded investments)</td>
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<tr>
<td></td>
<td>Dividends and other distributions</td>
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<td>Rights on liquidation of an investment</td>
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<td>For foreign denominated investments, exposure to foreign currency exchange risk</td>
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<td>One entity holding debt securities in another entity</td>
<td>Variable interest</td>
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<td></td>
<td>Credit risk on fixed interest</td>
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<tr>
<td>One entity holding a licence of a product candidate of another entity</td>
<td>Revenue earned from the use of the licence by the grantee</td>
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<td></td>
<td>Revenue earned by the granter from granting the licence (e.g., sales-based royalties)</td>
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<td></td>
<td>Access to proprietary knowledge or synergies gained from further development by the grantee</td>
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<tr>
<td>One entity provides services (e.g., research and development services or management services) to another entity</td>
<td>Compensation for services rendered by the service provider (e.g., milestone payments contingent on achievement of specified targets)</td>
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<tr>
<td></td>
<td>Cost savings for the entity that receives the service</td>
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<tr>
<td></td>
<td>Access to proprietary knowledge of the service provider</td>
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</table>
2.3 Link between power and returns

The third criterion for having control requires that an investor must also have the ability to use its power over the investee to affect the amount of the returns. This linkage is essential. Having power over an investee and exposure to variable returns, without the linkage between the two, is not enough. An investor that has power over an investee, but cannot benefit from that power, does not control that investee. An investor that has an exposure to a variable return from an investee, but cannot use its power to direct the activities that most significantly affect the investee's returns, does not control that investee.

When decision-making rights have been delegated, for example, to a steering committee or a management entity, or are being held for the benefit of others, it is necessary to assess whether the decision-maker is a principal or an agent to determine whether it has control. This is because if that decision-maker has been delegated rights that give the decision-maker power, it must be assessed whether those rights give the decision-maker power for its own benefit, or merely power for the benefit of others. As an agent cannot have control over the investee, it does not consolidate the investee. A principal may have control over the investee, and if so, would consolidate the investee.

This is especially relevant when an investee is set up and one of the investors (often the lead investor) is delegated powers by the other investors to direct the activities of the investee on behalf of all investors. Assessing whether the lead investor is making decisions as a principal, or simply carrying out the decisions made by all the investors (i.e., acting as an agent) will be critical to assessing control (or joint control). The assessment of principal versus agency situations is discussed in more detail in Chapter 5 of our General IFRS 10 publication.

Chapters 6 and 7 of our General IFRS 10 publication provide discussion on other matters to consider as part of the assessment of control in accordance with IFRS 10, including requirements to consider whether:

- Other parties, by virtue of their relationship with the investor (which could include related parties) are acting as de facto agents of the investor
- A portion of an investee should be treated as a deemed separate entity and, if so, whether it controls the deemed separate entity (a silo) and the specified assets of the silo.
3. Accounting for subsidiaries under IFRS 10

When an investor determines that it controls an investee, the investor (the parent) consolidates the investee (the subsidiary). IFRS 10 does not change the requirements of how to prepare consolidated financial statements; it simply carries forward the existing requirements of IAS 27 Consolidated and Separate Financial Statements (before its revision in 2011) into IFRS 10.

A parent consolidates a subsidiary from the date on which the parent first obtains control, and continues consolidating that subsidiary until the date on which control is lost. IFRS 3 Business Combinations defines the date of acquisition; i.e., the date on which control is first obtained. The term ‘date of acquisition’ is used even if a parent gains control without acquiring an interest or taking any action.

IFRS 10 deals with consolidation thereafter. The income and expenses of a subsidiary are included from the date of acquisition until the date on which the parent ceases to control the subsidiary. Income and expenses of a subsidiary are based on the values of the assets and liabilities recognised in the parent’s consolidated financial statements at the acquisition date.

More guidance on the consolidation procedures is included in Chapter 9 of our General IFRS 10 publication.

3.1 Transition to IFRS 10

As a result of applying the new definition of control in IFRS 10, there may be changes to which entities are consolidated and, depending on the facts and circumstances, changes to the non-controlling interests recognised.

If, on transition to IFRS 10, the control assessment is different from what it would have been under IAS 27/SIC-12, then an entity is required to retrospectively adjust comparative periods - subject to impracticability relief. If an investor determines that it controls an investee that was previously not consolidated, the investor applies acquisition accounting as at the date on which it obtained control:

- If the investee is a business (as defined in IFRS 3), the investor applies IFRS 3 to consolidate the investee (including any related goodwill) from the date control was obtained.
- If the investee does not meet the definition of a business, the investor measures the assets, liabilities and non-controlling interests in the previously unconsolidated investee applying the acquisitions method described in IFRS 3, except that goodwill is not recognised.

In addition to following the applicable accounting described below, the investor is required to provide comparative information and disclosures in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. An entity need only present the quantitative information for the immediately preceding period and need not include the effect on the current or earlier comparative periods. An entity may present this information for the current period or for earlier comparative periods, but it is not required to do so. IAS 1 Presentation of Financial Statements requires entities to present a third balance sheet (as at the beginning of the earliest comparative period) when an entity adopts a new accounting standard retrospectively.

Regardless of whether the investee meets the definition of a business, any difference between the amount of assets, liabilities and non-controlling interests recognised and the previous carrying amount of the investor’s involvement with the investee is recognised in equity at the beginning of the immediately preceding period or the earliest adjusted comparative period presented, as appropriate.
Retrospective application of IFRS 10 is not required in the following circumstances:

- If the control assessment is the same when applying IAS 27/SIC-12 and IFRS 10, i.e., an entity is not required to make adjustments to the previous accounting for its involvement with entities if the consolidation conclusion reached at the date of initial application is unchanged.
- If an investor’s interests in investees were disposed of during a comparative period, such that consolidation would not occur in accordance with either IAS 27/SIC-12 or IFRS 10 at the date of initial application (being the beginning of the annual period in which IFRS 10 is first applied).

More extensive guidance on the transition to IFRS 10 is included in Chapter 11 of our General IFRS 10 publication and IFRS Developments, Issue 35.

4. The concept of joint control in IFRS 11

Having established how control is defined under IFRS 10, it is now important to understand whether this control is exercised jointly, i.e., whether the collaboration arrangement (may or may not be a separate legal entity) is a joint arrangement that falls within the scope of IFRS 11.

Joint control is defined 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.”5 An entity that is a party to an arrangement should assess whether the contractual arrangement gives all the parties, or a group of the parties (e.g., a joint steering committee), control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that most significantly affect the returns of the arrangement (i.e., the relevant activities).

The key elements of joint control are, as follows:

- **Contractually agreed** — contractual arrangements set out the terms of the arrangements and are usually, but not always, written.
- **'Control' and 'relevant activities'** — IFRS 10 explains how to assess whether a party has control, and how to identify the relevant activities (see Section 2 above for further discussion).
- **Unanimous consent** — exists when any party sharing in joint control can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent (see Section 4.1 below)

Understanding the purpose and design of an arrangement is crucial to identifying whether there is joint control. The concept of joint control is discussed in more detail in Chapter 4 of our General IFRS 11 publication.

**How we see it**

While the control assessment under IFRS 10 is broad, the definition of ‘joint control’ under IFRS 11 is narrow. The clarification regarding when unanimous consent exists (see Section 4.1 below), in particular, could result in some collaboration arrangements, previously treated as joint ventures, falling outside the scope of IFRS 11.

Life sciences entities will need to apply significant judgement when assessing whether all the parties, or a group of parties, have joint control of an arrangement by considering all facts and circumstances.

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5 IFRS 11.7
4.1 Unanimous consent

IFRS 11 states that, in order for an arrangement to be jointly controlled, decisions about the relevant activities must require the unanimous consent of all the parties, or a group of the parties, that collectively control the arrangement. Nonetheless, it is not necessary for every party to the arrangement to agree to have unanimous consent; only those parties that collectively control the arrangement must agree.

The requirement to have unanimous consent ensures that no single party controls the arrangement. While the requirement for unanimous consent is not new, IFRS 11 clarifies when unanimous consent exists. Unanimous consent exists when any individual party with joint control of the arrangement can prevent any of the other parties, or a group of the parties, from making unilateral decisions about the relevant activities without its consent.

In some cases, a contractual arrangement may require a minimum proportion of the voting rights to make decisions. When that minimum can be achieved by more than one combination of the parties agreeing, the arrangement is not a joint arrangement unless it specifies which parties (or combination of parties) are required to agree unanimously to decisions about the relevant activities of the arrangement.

When assessing whether unanimous consent exists, the focus should be on decisions about the relevant activities. All of the relevant facts and circumstances should be considered in making an assessment, including whether:

- There is an ultimate voting authority (see Example 3 above) – this is typical in many life sciences arrangements. Importantly, if one party has the deciding vote in the event of a dispute or disagreement over one or more of the relevant activities, the arrangement would not be jointly controlled. Unanimous consent would not exist, since each of the remaining parties would not have the ability on their own to prevent the party with the deciding vote from making decisions without their consent. However, this would not necessarily mean the party with ultimate voting authority has control. The existence of an ultimate voting authority would require further analysis to assess whether it affects the control assessment.

- The arrangement includes other terms and conditions relating to the resolution of disputes, and/or arbitration – the existence of such terms and conditions may not prevent the arrangement from being jointly controlled and, consequently, from being a joint arrangement, as long as they do not give one party ultimate voting authority over one or more of the relevant activities.

- Additional contractual agreements need to be considered – it may be necessary to evaluate multiple agreements together, to understand the purpose and design of an arrangement and to determine if there is joint control. A party may appear to have joint control of a joint arrangement when considering one agreement in isolation, but that party may not have joint control when considered in the full context of the other agreements.

While in most cases, we expect the terms establishing joint control to be explicitly stated in the contractual agreement, joint control may exist implicitly. That is, unanimous consent of the parties may be explicitly required by the contractual arrangement or it may be implicitly required, depending on the specific facts and circumstances. For example, if two parties have equal (50%) ownership of a separate vehicle, joint control could exist even if the terms of the contractual arrangement do not require unanimous consent over the relevant activities.

Determining whether joint control exists implicitly depends on a careful evaluation of the contractual terms of the arrangement. It is possible that two parties have equal ownership interests, but the relevant activities are directed by one party according to the contractual arrangement between them. In this case, the party that has the contractual right to direct the relevant activities would have control (i.e., joint control would not exist).
5. Classifying and accounting for joint arrangements under IFRS 11

5.1 Unit of account and master agreements

IFRS 11 does not explicitly specify the unit of account for a joint arrangement. However, it seems that the IASB intended for the unit of account for a joint arrangement to be the activity that two or more parties have agreed to control jointly.

When identifying the unit of account for a joint arrangement, generally it is appropriate to start by examining the contractual agreement. Frequently, each contractual agreement creates a single joint arrangement. However, some contracts may contain more than one joint arrangement. For example, a master agreement (referred to in IFRS 11 as a ‘framework agreement’) may contain the terms and conditions for numerous separate joint arrangements.

Example 5 illustrates a case where a collaboration arrangement between two life sciences entities may be accounted for as several distinct joint arrangements, each of which is classified as either a joint operation or a joint venture.

**Example 5 — Master agreement for research and development and distribution activities**

A single contract between two life sciences entities specifies the terms and conditions related to research and development and distribution activities, and dictates how these activities will be carried out in various jurisdictions through several entities.

The investors may determine that this collaboration arrangement contains several discrete joint arrangements (one for each activity in each jurisdiction, which corresponds to an entity). In this case, each entity would likely be classified as either a joint venture or a joint operation. This could possibly be the case if the terms and conditions relating to each activity were distinct for each entity.

**Variation** — A contract between two life sciences entities specifies the terms and conditions related to research and development and distribution activities, and dictates how these activities will be carried out in various jurisdictions. However, one investor has the ability to direct the relevant activities in certain entities (e.g., the entity in Country A), and the other investor has the ability to direct the relevant activities for others (e.g., the entity in Country B). In this case, there would not be joint control between the two investors. Rather, each investor controls its respective entities.
5.2 Classification of a joint arrangement

Once it has been established there is joint control, the joint arrangement will be classified as either a joint operation or a joint venture, which is different from the classification and accounting required under IAS 31 Interests in Joint Ventures (see Section 6 below).

Determining the correct classification will involve judgement and will require a thorough analysis of the parties' rights and obligations under the arrangement. This includes considering the structure and legal form of the arrangement, the terms agreed by the parties in the contractual arrangement and, when relevant, other facts and circumstances.

The classification of a joint arrangement under IFRS 11 may have a significant impact on an entity’s financial statements (Section 5.4 discusses the accounting implications). In addition, IFRS 12 requires entities to disclose the judgements and assumptions made in arriving at this conclusion. Chapter 9 of our General IFRS 11 publication provides more guidance on IFRS 12’s disclosure requirements for joint arrangements.

The classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement in the normal course of business:

- When an entity has rights to the arrangement’s assets and obligations for the arrangement’s liabilities, the arrangement is a joint operation. The party that has joint control of a joint operation is called joint operator.
- When an entity has rights to the net assets of the arrangement, the arrangement is a joint venture. This entity is then defined as a party who has joint control of a joint venture and called joint venturer.

Diagram 4 — Classifying a joint arrangement

<table>
<thead>
<tr>
<th>Step</th>
<th>Question</th>
<th>Yes</th>
<th>No</th>
<th>Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Is the joint arrangement structured through a separate vehicle?</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Does the legal form of the separate vehicle give the parties rights to the assets and obligations for the liabilities relating to the arrangement?</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Do the terms of the contractual arrangement give the parties rights to the assets and obligations for the liabilities relating to the arrangement?</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Do other facts and circumstances give the parties rights to the assets and obligations for the liabilities relating to the arrangement?</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

Joint operation

Joint venture
The IASB generally expects that all parties to a joint arrangement would reach the same conclusion regarding classification of that joint arrangement.

The IASB generally expects that all parties to a joint arrangement would reach the same conclusion regarding the classification of the arrangement. To reach different conclusions would mean that the parties have different rights to assets and obligations for the liabilities within the same arrangement, which the IASB believes would be rare.

When classifying a joint arrangement as either a joint operation or a joint venture, the first step is to assess whether there is a separate vehicle. A separate vehicle is defined in IFRS 11 as ‘a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have legal personality’. If there is no separate vehicle, the joint arrangement is automatically a joint operation. If there is a separate vehicle, the following factors will also need to be considered before concluding whether the arrangement is a joint venture:

- Legal form of the separate vehicle
- Contractual terms and conditions
- Other facts and circumstances

Once it is determined that a separate vehicle exists, the next step is to analyse the legal form of the separate vehicle. This is important because a joint arrangement that is structured through a separate vehicle will not automatically fit into the joint venture classification – it could be a joint operation, depending on the other facts and circumstances that exist. This is a significant change from IAS 31, where the accounting solely depends on whether a separate vehicle exists. Under IFRS 11, the legal form of the separate vehicle must be assessed to determine whether it gives the parties rights to the net assets, or rights to the assets and liabilities for the obligations of the arrangement. In other words, does the legal form of the separate vehicle confer separation between the parties and the separate vehicle itself?

The assessment of the rights and obligations conferred upon the parties by the legal form of the separate vehicle is sufficient to conclude that the arrangement is a joint operation only if the parties conduct the joint arrangement in a separate vehicle whose legal form does not confer separation between the parties and the separate vehicle (i.e., the assets and liabilities held in the separate vehicle are the parties’ assets and liabilities).

If the legal form of the separate vehicle confers separation between the parties and the separate vehicle, the next step is to examine the contractual terms of the arrangement to determine whether they unwind the effects of the legal form by providing the parties with rights to the net assets (a joint venture) or rights to the assets and obligations for the liabilities (a joint operation). The requirement to focus on the nature and substance of the rights and obligations of the joint arrangement is a change from IAS 31, which solely looks to the form of the arrangement.
Table 2 – Examples of common contractual terms in a joint arrangement

<table>
<thead>
<tr>
<th>Rights to assets</th>
<th>Indicators of a joint operation</th>
<th>Indicators of a joint venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rights to assets</td>
<td>The parties share all interests (e.g., rights, title or ownership) in the assets relating to the arrangement in a specified proportion.</td>
<td>The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement’s assets. The parties have no interests (e.g., no rights, title or ownership) in the assets of the arrangement.</td>
</tr>
<tr>
<td>Obligations for liabilities</td>
<td>The parties share all liabilities, obligations, costs and expenses in a specified proportion.</td>
<td>The joint arrangement is liable for the debts and obligations of the arrangement.</td>
</tr>
<tr>
<td>Obligations for liabilities</td>
<td>The parties are jointly and severally liable for the obligations of the arrangement.</td>
<td>The parties are liable under the arrangement only to the extent of their respective investments in the arrangement, or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.</td>
</tr>
<tr>
<td></td>
<td>The parties are liable for claims raised by third parties.</td>
<td>Creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.</td>
</tr>
</tbody>
</table>

Guarantees

Parties to joint arrangements may provide guarantees to third parties (e.g., lenders or regulators) on behalf of the joint arrangement. For example, in the life sciences sector, a party to a joint arrangement might provide a guarantee or commitment that:

- Services provided by the joint arrangement to the third party will be of a certain quality or nature
- The joint arrangement will repay funding received from the third party

Or

- It will support the joint arrangement in the event of distress (e.g., it will issue a guarantee to cover all trade liabilities or subordinate its own claims to third party claims)

It may at first appear that providing a guarantee (or commitment to provide a guarantee) gives a party a direct obligation for a liability, which could indicate that the joint arrangement should be classified as a joint operation. However, IFRS 11 states this is not the case. The mere existence of the guarantee does not affect the classification of the joint arrangement.

Although perhaps counter-intuitive, the fact that a guarantee is not determinative of the classification of a joint operation is consistent with the principles in IFRS 11. This is because the guarantee does not give the guarantor a present obligation for the underlying liabilities. Accordingly, a guarantee is not determinative of having an obligation for a liability.

However, if the issuer of the guarantee is required to pay or perform under that guarantee, this may indicate that the facts and circumstances have changed. Alternatively, the issuance of a guarantee may be accompanied by a change in the contractual terms of the arrangement. This change would trigger a reassessment of whether the arrangement is still subject to joint control, and if so, whether the joint arrangement is a joint operation or a joint venture.

Regardless of the impact of a guarantee on the classification of a joint arrangement, the entity that provides the
guarantee must still account for the guarantee in accordance with IFRS 9, IAS 39 or IAS 37.

5.2.1 Other facts and circumstances to consider in classifying joint arrangements
If the preliminary assessment of the legal form and the contractual terms indicate that a joint arrangement may be a joint venture, the final factor the parties must consider is whether any other facts and circumstances indicate they each have rights to the assets and obligations for the liabilities, making the arrangement a joint operation.

When considering other facts and circumstances associated with a joint arrangement that is structured through a separate vehicle, an entity evaluates two critical questions about the arrangement:

1. Have the parties designed the arrangement so that its activities primarily aim to provide the parties with an output (i.e., the parties have rights to substantially all of the economic benefits of the assets held in the separate vehicle)?

2. Is the arrangement designed so that it depends on the parties on a continuous basis to settle its liabilities?

If the answer to these questions is yes, the arrangement is a joint operation, because it would be difficult to prove that there is a degree of separation between the parties and the arrangement itself. Judgement will be needed to assess whether these criteria are met. Table 3 below provides certain other facts and circumstances that might be present in a joint arrangement and that would be relevant to the classification of the arrangement as a joint operation or a joint venture.

<table>
<thead>
<tr>
<th></th>
<th>Indicators of a joint operation</th>
<th>Indicators of a joint venture</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restrictions on selling output</td>
<td>Restricted from selling output to third parties</td>
<td>No restrictions; may sell output to third parties</td>
</tr>
<tr>
<td>Requirements to purchase output</td>
<td>Parties (individually or collectively) must purchase substantially all output produced</td>
<td>No requirements; third parties may purchase output</td>
</tr>
<tr>
<td>Source of cash flows to pay liabilities</td>
<td>The parties provide cash flows through their purchases of output</td>
<td>Cash flows received from third parties through their purchases of output</td>
</tr>
<tr>
<td>Expected financial performance</td>
<td>Designed to operate at break-even or to generate losses that will be funded by the parties</td>
<td>Designed to generate a profit</td>
</tr>
</tbody>
</table>
Example 6 — A joint arrangement involving a separate legal entity

Two large pharmaceutical companies, A and B, jointly establish a separate legal entity (company C) to jointly develop a new drug. A and B each have a 50% ownership interest in C. Establishing C as a company enables the separation of C from A and B and, as a consequence, the assets and liabilities held in C are the assets and liabilities of C. The contract between A and B does not specify whether A or B have rights to the assets or obligations for the liabilities of C. C is managed by an independent board of directors that makes the final decisions on the relevant activities of C. The contract specifies the following:

- A and B agree to fund C and to split any revenues generated from selling the drug developed by C in a ratio of 50:50.
- A and B are liable only to the extent of their respective investments in C, or to their respective obligations to contribute any unpaid or additional capital to C, or both.

Taking into consideration the inherent uncertainty related to the development of the drug (i.e., the potential success rate), A and B expect C to be profit-generating in the long term.

Analysis

As C is able to sell and distribute the drug it has developed to third parties, it is assuming demand, production and credit risks. As such, A and B would not have obligations for substantially all of the liabilities or rights to substantially all of the economic benefits of the assets of C. The assessment of the rights and obligations conferred upon A and B by the legal form of the separate vehicle indicates that the parties have rights to the net assets of C. In addition, the long-term prospects of C are expected to be profit-generating. Therefore, the joint arrangement would likely be classified as a joint venture.

Cash contributed at the inception of an arrangement

IFRS 11 indicates that if a joint arrangement depends on the parties for settling its liabilities on a continuous basis, it would be indicative of a joint operation. In some cases, parties to a joint arrangement may provide cash flows at inception of a joint arrangement, but are not expected to provide cash flows thereafter. Some have questioned whether, in such a situation, this would mean that the parties to the joint arrangement have provided “substantially the only source of cash flows”.

Careful assessment of the specific circumstances is needed to understand why cash was contributed and how this might affect the classification of the joint arrangement. However, in our view, the provision of cash flows at the inception of a joint arrangement, and/or the expectation that no other parties will provide cash flows until the end of an activity, are not conclusive in determining whether there is an obligation for a liability. That is, it is not conclusive whether the joint arrangement is a joint operation or a joint venture.

Chapter 5 of our Applying IFRS 11 publication provides more guidance on the classification joint arrangements.

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6 This example has been adapted from Example 4 in IFRS 11.B26.
Example 7 – Classifying joint arrangements (comprehensive example)

Assume Pharma is a public company and Biotech is a privately-held company that is primarily funded by venture capital entities. Pharma and Biotech enter into a collaboration arrangement whereby Biotech licenses to Pharma, for the term of the arrangement, the exclusive global commercialisation rights for a new drug (Product), which is in Phase II clinical trials at the inception of the arrangement. In exchange, Pharma pays Biotech an upfront fee of CU50 million, additional payments of CU50 million if certain development milestones are achieved and a royalty based on Pharma’s sales of the commercialised product. In addition, Pharma will reimburse a portion of Biotech’s development costs up to CU10 million. In connection with the collaboration arrangement, Pharma buys 10% of Biotech’s outstanding share capital for CU3 million, which is assumed to be the fair value of the acquired shares of Biotech.

The collaboration arrangement requires that Pharma and Biotech establish and share control of a joint steering committee, which provides oversight of the protocol that Biotech uses to further develop Product and in which Pharma and Biotech are equally represented. Further assume that Product is the only product candidates being developed by Biotech.

The first step to analyse this scenario is to identify the relevant activities and who directs them. The relevant activity in this collaboration arrangement is developing Product. The development of Product is overseen and decided upon via a joint steering committee.

Secondly, it must be established whether full or joint control is exercised in this collaboration arrangement. The collaborative research agreement is jointly controlled by both Pharma and Biotech because decisions are made in a joint steering committee through which the parties have collective control over the collaboration arrangement.

Biotech is a separate vehicle, which may indicate that the joint arrangement is a joint venture. The equity stake acquired in Biotech is also one important aspect to consider in determining control. In this example, Pharma obtained 10% of the voting rights.

Even though there are indicators for a joint venture, indicators for the joint arrangement to be classified as a joint operation need to be considered:

- The parties share all rights to the assets, i.e., Biotech has full rights of the equipment to develop the product, whilst Pharma, in turn, will obtain the licence to globally commercialise the product under development.
- The rights to the commercial licence are restricted to Pharma. Biotech is contractually unable to sell the licence to a third party.
- Pharma provides cash flows in order to facilitate Biotech’s research and development activity.

The analysis above would indicate that the arrangement is a joint operation.

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7 A similar example that applies the US GAAP variable interest model is available. Please see our Technical Line – The effects of the revised Variable Interest Model in the life sciences industry available at ey.com/us/accountinglink.
5.3 Accounting for joint operations

The accounting for joint operations follows the principle that IFRS 11 establishes: the accounting for joint arrangements should reflect the rights and obligations that the parties have as a result of their interests in the joint arrangement, regardless of such arrangement's structure or legal form. A joint operator is required to recognise the following 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 the 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
- Its expenses, including its share of any expenses incurred jointly

The accounting and measurement for each of these items is made in accordance with the applicable IFRSs. Careful attention should be given to the nature of the rights to the assets, and the obligations for the liabilities (or the share of assets, liabilities, revenues, and expenses) if any, of the joint operation. That is, to what are the joint operators actually entitled and for what are they responsible? This is often incorrectly referred to as proportionate consolidation (see Section 5.3.1 below for further discussion on this distinction).

Chapter 6 of our General IFRS 11 publication provides more guidance on the accounting for joint operations.

5.3.1 Joint operation accounting vs proportionate consolidation

There are two main differences between the accounting for a joint operation and proportionate consolidation:

- While proportionate consolidation bases the recognition of assets, liabilities, revenues and expenses on the ownership interest that the entity has in the joint operation, the accounting for joint operations under IFRS 11 bases this recognition on the rights and obligations specified in the contractual arrangement.
- IAS 27 (as revised in 2011) now specifically states that in their separate financial statements entities must account for investments in subsidiaries, joint ventures and associates. The parties’ interests in a joint operation are therefore recognised both in their separate and consolidated financial statements, while previously entities could choose to account for jointly controlled entities at cost or in accordance with IAS 39 as a single line item in their separate financial statements.

Joint operation accounting and proportionate consolidation are technically different. However, they could result in the same accounting in some circumstances. Example 8 compares proportionate consolidation with joint operation accounting as described in IFRS 11.

Chapter 6 of our General FRS 11 publication provides more guidance on the accounting for joint ventures, including the accounting requirements for parties to a joint operation that do not have joint control.
Example 8 – Proportionate consolidation vs joint operation accounting in IFRS 11
Party A and Party B are involved in a 50:50 joint arrangement, which is conducted through Entity C. The joint arrangement uses the specialised equipment owned by Party A to develop a new drug. Party A and Party B each own 50% of the equity (e.g., shares) in Entity C. However, the contractual terms of the joint arrangement state that Party A has rights to 100% of its equipment and Party B has an obligation for 100% of the joint arrangement’s debt. Parties A and B have rights to all other assets in Entity C, and obligations for all other liabilities in Entity C in proportion to their equity interests (i.e., 50%). Because Party A and Party B have contractual rights to the assets and obligations for the liabilities of Entity C, Entity C is a joint operation under IFRS 11.

<table>
<thead>
<tr>
<th>Item</th>
<th>100% amount</th>
<th>IAS 31 - Proportionate consolidation</th>
<th>IFRS 11 - Joint operation accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Party A 50%</td>
<td>Party B 50%</td>
</tr>
<tr>
<td>Specialised equipment*</td>
<td>1,000</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td>Other assets</td>
<td>1,500</td>
<td>750</td>
<td>750</td>
</tr>
<tr>
<td>Debt**</td>
<td>(500)</td>
<td>(250)</td>
<td>(250)</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>(100)</td>
<td>(50)</td>
<td>(50)</td>
</tr>
</tbody>
</table>

* Party A has rights to 100% of the specialised equipment.
** Party B has obligations for 100% of the debt.

The different presentation of this joint arrangement on the face of the financial statements results from the fact that proportionate consolidation of jointly controlled entities in IAS 31 bases the recognition of assets, liabilities, revenues and expenses on the ownership interest that Party A and Party B have in Party C, while the accounting for joint operations under IFRS 11 bases this recognition on the rights and obligations specified in the contractual arrangement for the underlying assets, liabilities, revenues and expenses of the joint arrangement.

5.4 Accounting for joint ventures
Jointly controlled entities under IAS 31, in which parties have rights to the joint arrangement’s net assets, will now either be classified and accounted for as joint ventures under IFRS 11 or as joint operations (see Section 6 below).

Those that are joint ventures under IFRS 11 will be required to apply equity accounting to their investments in joint ventures, in accordance with IAS 28.

Chapter 7 of our General FRS 11 publication provides more guidance on the accounting for joint ventures, including the accounting requirements for parties to a joint venture that do not have joint control.
6. The impact of transitioning to IFRS 11

The impact of transitioning to IFRS 11 depends on how the joint arrangement was classified under IAS 31, the accounting method applied under IAS 31, and the classification under IFRS 11 as either a joint operation or a joint venture.

Diagram 5 compares the classification of joint arrangements under IAS 31 to the classification under IFRS 11. Investments in jointly controlled operations and jointly controlled assets under IAS 31 will be considered investments in joint operations under IFRS 11, by virtue of the fact that they are not structured through a separate vehicle.

A joint arrangement that is structured through a separate vehicle will not automatically fall into the joint venture classification — it could be a joint operation, depending on the other facts and circumstances that exist. This is one of the major differences between IAS 31 and IFRS 11.

The accounting for joint ventures under IFRS 11 will likely cause the most significant changes when adopting the new standard. IAS 31 allowed parties to elect either the equity method or proportionate consolidation method to account for their investments in jointly controlled entities. IFRS 11 removes this election and requires investors to account for:

- Investments in joint ventures using the equity method in accordance with IAS 28 (proportionate consolidation is no longer an option)
- Investments in joint operations based on their rights to, and obligations for, the underlying assets, liabilities, revenue and expenses in accordance with the relevant IFRS
### Table 4 – The impact of transitioning to IFRS 11

<table>
<thead>
<tr>
<th>Classification under IAS 31</th>
<th>Accounting method applied under IAS 31</th>
<th>Classification under IFRS 11</th>
<th>Transition impact on adoption of IFRS 11</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jointly controlled entity</td>
<td>Proportionate consolidation</td>
<td>Joint Venture</td>
<td>The joint venturer would apply equity accounting in accordance with IAS 2B. The transition from proportionate consolidation to equity accounting is discussed below.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Joint Operation</td>
<td>A joint operator would recognise its assets, liabilities, revenue and expenses, and/or its share of assets, liabilities, revenues and expenses incurred jointly. It appears that IAS 8 would apply to any adjustments on adoption.*</td>
</tr>
<tr>
<td></td>
<td>Equity accounting</td>
<td>Joint Venture</td>
<td>The joint venturer would apply equity accounting in accordance with IAS 2B. Adjustments are not anticipated on adoption, but it appears IAS 8 would apply.*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Joint Operation</td>
<td>A joint operator would recognise its assets, liabilities, revenue and expenses, and/or its share of assets, liabilities, revenues and expenses incurred jointly. The transition from equity accounting to joint operation accounting is discussed below.</td>
</tr>
<tr>
<td>Jointly controlled assets</td>
<td>Recognise its share of assets, its share of liabilities, its income, its expenses and its share of expenses</td>
<td>Joint Operation</td>
<td>A joint operator would recognise its assets, liabilities, revenue and expenses, and/or its share of assets, liabilities, revenues and expenses incurred jointly. Adjustments are not anticipated on adoption, but it appears IAS 8 would apply.*</td>
</tr>
<tr>
<td>Jointly controlled operations</td>
<td>Recognise its assets, liabilities, expenses and its share of income</td>
<td>Joint Operation</td>
<td>A joint operator would recognise its assets, liabilities, revenue and expenses, and/or its share of assets, liabilities, revenues and expenses incurred jointly. Adjustments are not anticipated on adoption, but it appears IAS 8 would apply.*</td>
</tr>
</tbody>
</table>

* Because these situations are not specifically addressed by IFRS 11, it would appear that IAS 8 applies. IAS 8 requires retrospective adoption of a new accounting standard, when specific transition provisions are not given.
To transition from equity accounting to joint operation accounting, a joint operator would:

- Derecognise the equity accounted investment (including any items that formed part of the entity’s net investment under IAS 28 (2011) as at the beginning of the earliest period presented, e.g., 1 January 2012)
- Recognise rights to assets and obligations for liabilities based on contractual agreements and relevant IFRS (e.g., IAS 16 for property, plant and equipment)
  - Recognise any goodwill that formed part of the carrying amount of the equity method investment
- Measure the rights and obligations based on the information used by the entity in applying the equity method
  - Measure as required by other IFRS
  - Recognise any difference as reduction of goodwill, and/or retained earnings
  - Do not apply initial recognition exemption under IAS 12 Income Taxes
- Account for rights and obligations after initial recognition in accordance with relevant IFRS

To transition from proportionate consolidation to equity accounting, a joint venturer would:

- Recognise the investment at the beginning of the earliest period presented (e.g., 1 January 2012)
- Aggregate the carrying amounts of the assets and liabilities that it had previously proportionately consolidated
  - Include any goodwill arising upon acquisition allocated from cash generating units, if necessary
  - Disclose amounts that were aggregated into the investment cost basis
  - Do not apply initial recognition exemption under IAS 12
- Assess for potential indicators of impairment in accordance with IAS 39
  - If they exist, test for impairment by applying IAS 36 Impairment of Assets
  - Recognise any impairment write-down in retained earnings at the beginning of the earliest period presented.
- Account for the investment in the joint venture using the equity method after initial recognition

It should be noted that, after issuing IFRS 11, the IASB amended the standard to require adjusted comparative information for the immediately preceding period only. Nevertheless, this information may be provided for earlier periods if the entity so chooses. If earlier comparative information is not restated, this should be made clear on the face of the financial statements.

As discussed in Table 4 above, some transition situations are not specifically addressed by IFRS 11. Therefore, it would appear that IAS 8 applies in those situations. IAS 8 requires retrospective application of a new accounting standard when specific transition provisions are not given by the applicable standard. Any differences that arise as a result of transitioning to IFRS 11 would be recognised in opening retained earnings for the earliest period that the entity restates.

As a reminder, IAS 1 Presentation of Financial Statements requires entities to present a third balance sheet (as of the beginning of the earliest comparative period) when an entity adopts a new accounting standard retrospectively.

Refer to Chapter 10 of our General IFRS 11 publication and IFRS Developments, Issue 35 for further information on transitioning to IFRS 11, including the required disclosures.8

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8 Available at www.ey.com/ifrs
7. Preparing to adopt IFRS 10, IFRS 11 and IFRS 12

At a minimum, adopting IFRSs 10, 11 and 12 (and the related amendments to IAS 27 and IAS 28) will require time and effort, and external assistance may be needed. Identifying the population of potential investments that require reconsideration is often a time-consuming and difficult task. Management should plan accordingly.

These standards could have a significant impact on the ongoing operations of an entity. Therefore, when planning to transition, the following should also be considered:

- New systems and processes (or amendments to existing systems and processes) may become necessary
- Finance and legal personnel should be trained to assess the potential accounting impact of newly agreed collaboration arrangements as the accounting treatment should appropriately reflect the substance of the arrangement
- Consider potential implications on (group-wide) internal controls, income taxes and any potential involvement with structured entities

In addition, an entity's processes for preparing financial statements, including IT systems, may need to be adapted to be able to capture new information, for example, for consolidation into the group financial statements or to ensure the finance personnel have sufficient information to comply with the disclosure requirements in IFRS 12.

IFRS 12 will require the disclosure of significant judgements and assumptions made by management in determining whether it controls another entity, whether there is joint control and whether an arrangement structured through a separate vehicle is a joint venture or a joint operation. When an entity controls an investee, it must disclose all relevant information that enables the users of its financial statements to understand the composition of the group and the interest that non-controlling interests have in the group's activities. If management concludes that it does not control another entity, the information used to make the judgement must be disclosed in the financial statements.

Also, the changes upon transitioning to joint arrangement accounting under IFRS 11 will impact the presentation of the financial statements of affected entities. For example, changing from proportionate consolidation to equity accounting would cause the investment in the joint arrangement to change from being presented as multiple line items throughout the financial statements, to single equity-accounted line items. This could impact key metrics, such as EBITDA. Under proportionate consolidation, a joint venturer's share of any interest or tax of the joint arrangement would have been presented outside of EBITDA. Under equity accounting, such amounts would generally be included in a single line item in profit or loss and forms part of EBITDA. An entity needs to disclose information that enables the users of its financial statements to evaluate the nature, extent and financial effects of its interest in the joint arrangement and the nature of and changes in the risks associated with such interest.

For more information on the practical implications of these changes for your business, prefer to Chapter 11 of our General IFRS 10 publication and Chapter 10 of our General IFRS 11 publication.
How we see it

Adopting this suite of standards will significantly impact entities’ financial reporting. Entities will need to disclose information about significant judgements and assumptions they made in determining the control they exercise over an investee and the type of joint arrangement they have entered into. Making these assessments about the entities in which it has an interest and gathering the required information for disclosure will be time consuming.

In preparing to adopt these standards entities should take a longer-term view. Following the transition period, the disclosures required on an ongoing basis in relation to subsidiaries and joint arrangements are expected to be more comprehensive than is currently the case. These requirements, as well as the need to continuously assess control and joint control, could impact the time and cost involved in complying with these standards in future periods.

8. Convergence with US GAAP

The issuance of IFRS 10 and IFRS 11 is a significant step towards convergence with US GAAP, and was a part of the 2006 Memorandum of Understanding between the IASB and the FASB. However, there are still significant differences that life sciences entities should be aware of.

8.1 Differences between IFRS 10 and ASC 810 Consolidation

The main differences that will continue to exist between IFRS 10 and Accounting Standard Codification (ASC) 810 are summarised in the following table.

<table>
<thead>
<tr>
<th></th>
<th>IFRS 10</th>
<th>ASC 810</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation model</td>
<td>Single model for all entities</td>
<td>Two models – one for variable interest entities (VIEs) and one for voting interest entities</td>
</tr>
<tr>
<td>Control with less than a majority of voting rights (de facto control)</td>
<td>Control can result from holding less than a majority of voting rights based on the facts and circumstances</td>
<td>Concept does not exist</td>
</tr>
<tr>
<td>Potential voting rights in control assessment</td>
<td>May provide control if substantive</td>
<td>Concept does not exist</td>
</tr>
<tr>
<td>Principal-agent evaluation in control assessment</td>
<td>Based on combination of economic considerations, rights held by others and scope of decision-making authority</td>
<td>• VIEs – based primarily on economic considerations</td>
</tr>
<tr>
<td>Consideration of removal rights and participating rights in control assessment</td>
<td>The more investors that are required to agree to exercise the rights, the less likely that those rights are substantive</td>
<td>• VIEs – substantive if unilaterally exercisable by a single party</td>
</tr>
<tr>
<td>Consideration of related parties in control assessment</td>
<td>Aggregate interests of parties acting on behalf of the investor when evaluating control</td>
<td>• VIEs – aggregate interests of related parties and de facto agents in certain cases</td>
</tr>
</tbody>
</table>

Accounting for collaborations in the life sciences sector — challenges in applying IFRS 10 and IFRS 11
Table 5 – Differences between IFRS 10 and ASC 810 (cont’d)

<table>
<thead>
<tr>
<th></th>
<th>IFRS 10</th>
<th>ASC 810</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment company/entity accounting</td>
<td>Concept does not currently exist — all reporting entities consolidate controlled investments</td>
<td>Investment companies (as defined) record all investments at fair value</td>
</tr>
</tbody>
</table>
| Decrease in ownership provisions (with and without loss of control) | Applies to all subsidiaries, including those that are not businesses, have non-profit activities, involve sales of in-substance real estate or involve conveyances of oil and gas mineral rights | ▶ Applies to businesses and non profit activities  
▶ Scope excludes sales of in-substance real estate and conveyances of oil and gas mineral rights |
| Different reporting dates of parent and subsidiary | The effects of significant events occurring between reporting dates when different dates are used are adjusted for in the financial statements | The effects of significant events occurring between reporting dates when different dates are used are disclosed in the financial statements |
| Different accounting policies of parent and subsidiary | The accounting policies of the subsidiary are required to be the same as those of the group | The reporting entity and subsidiary are not required to have the same accounting policies |

8.2 Differences between IFRS 11 and ASC 323 Investments – equity method and joint ventures

In US GAAP, joint ventures are entities whose operations and activities are jointly controlled by a group of equity investors, which are referred to as ‘venturers’. To meet the definition of a joint venture in US GAAP, we believe an arrangement must have all of the following characteristics:

▶ The arrangement must be organised within a separate legal entity
▶ The entity must be under the joint control of the venturers
▶ The venturers must be able to exercise joint control of the entity through their equity investments

The following list highlights certain significant conceptual differences exist between IFRS 11 and US GAAP:

▶ US GAAP does not have a concept for joint arrangements that are conducted outside a legal entity. Joint operations under IFRS 11 that are conducted outside a legal entity may be similar to collaborative arrangements under US GAAP.
▶ Under US GAAP, the definition of significant decisions applied when evaluating joint control over a joint venture is the voting interest model definition, which is broader than the definition of ‘relevant activities’ in IFRS 11. While in many cases, IFRS and US GAAP may result in identifying the same significant decisions as part of the joint control evaluation, the broader definition in US GAAP could result in more decisions being identified.
▶ In US GAAP, the concept of unanimous consent is stricter than in IFRS 11. In US GAAP, joint control exists only when all of the significant decisions related to an entity require the unanimous consent of all of the venturers (the only exception to the requirement for unanimous consent among the equity holders relates to small, passive interests held in public ownership). Under IFRS 11, a joint arrangement can be jointly controlled even...
when it has passive interest holders that do not participate in joint control, as described in Section 5.2 above.

- In US GAAP, we believe the venturers must be able to exercise joint control of the entity through their equity investments. Entities controlled through rights granted via interests other than the equity interests would need to be evaluated for possible consolidation under the VIE model. In IFRS 11, joint ventures may be jointly controlled through rights granted via interests other than equity interests.

- Arrangements that are structured through a separate vehicle and in which the parties have rights to the assets and obligations for the liabilities, are accounted for differently. If the vehicle meets the definition of a joint venture, US GAAP would require the venturers to apply equity method accounting. In contrast, IFRS will require joint operation accounting, as described in Section 5.4.

**Looking ahead**

Entities in the life sciences sector will continue to manage risk using joint arrangements and investments in other entities. As a result, IFRS 10 and IFRS 11, along with the disclosure requirements in IFRS 12, are expected to have a widespread impact on a large number of entities in the sector.

Life sciences entities need to act now to address the potential changes to their businesses. This publication is intended to assist life sciences entities to have a better understanding of the nature of the changes. Moreover, significant effort will be required to successfully implement all of the changes. Entities need to review their existing arrangements to identify those that are within the scope of either IFRS 10 or IFRS 11 and then assess how the accounting may be affected.

These assessments will require significant judgement on the part of management. As the rights and obligations provided to the parties to the contract will ultimately drive the accounting, entities must ensure that they have a detailed understanding of the specific rights and obligations of each of their existing arrangements in order to determine the impact of the new standards. Given the unique nature of the various arrangements that currently exist, and are continuing to emerge, entities will need to individually analyse each contract to be able to complete a full assessment. This task will be further complicated by the number and complexity of the arrangements to which a life sciences entity may be party.

Life sciences entities will need to develop robust systems and processes, not only to complete the initial assessment, but also to enable the ongoing assessment of current arrangements. Life sciences entities that report both under IFRS and US GAAP will need to pay special attention to the significant differences that exist between the two sets of reporting standards.
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