Joint Arrangements and the Accounting Implications

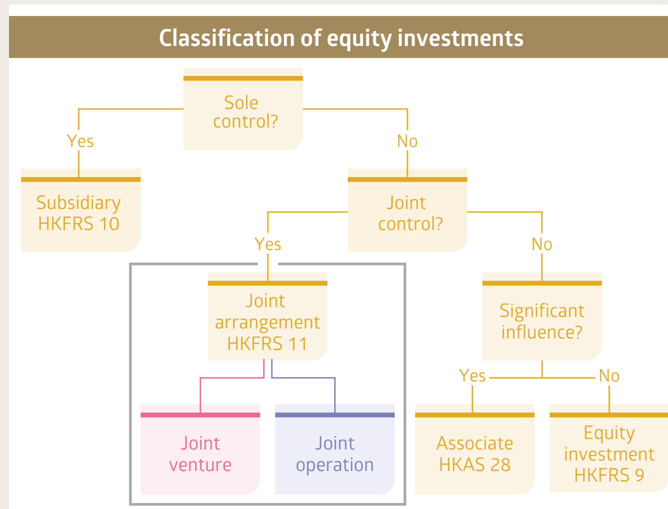
In today's business landscape, it is common for corporations to expand their interests by exploring new business opportunities and avenues. This expansion typically involves establishing new entities or investing in existing ones, aiming to foster business growth and seize emerging opportunities. Besides traditional investment methods such as controlling subsidiaries, influential associates, and passive equity interest investments, corporations often opt for joint arrangements to collectively pursue mutual business goals.

In the following section, we will provide a concise overview of joint arrangements, examine their merits and drawbacks, delve into the accounting classification of different joint arrangements - joint ventures and joint operations, explore their pertinent accounting implications, and use CLP Group's case studies to illustrate these points.

What is a joint arrangement?

A joint arrangement represents a contractual agreement between two or more parties collaborating on specific economic activities or projects. This arrangement is especially prevalent in industries demanding substantial capital investment, such as the energy and utilities sector, where CLP Group operates.

From an accounting perspective, a defining characteristic of a joint arrangement is the exercise of joint control by the involved parties. The joint control is typically established through contractual agreements or other formal arrangements. Joint control implies that decisions significantly affecting the returns of the invested entity necessitate unanimous agreement from all controlling parties involved. These distinctive elements set joint arrangements apart from other collaborative forms involving multiple investors.



Why establish a joint arrangement?

To achieve specific commercial goals and optimise the risk and return profile of an investment, investors should understand the pros and cons of the form of investment. The following outline several significant advantages and disadvantages related to joint arrangements:

Advantages

- **Risk Sharing**
  Financial and operational risks are shared among the joint arrangement partners ("Partners"), thereby lessening individual exposure to financial burdens without full commitment.
- **Resource and Expertise Sharing**
  Enriching the overall capabilities as Partners contribute complementary resources, skills and expertise.
- **Cost Efficiency**
  Enable cost and resource sharing, operational efficiency improvements, and achieving economies of scale, resulting in cost savings.
- **Market Entry and Expansion**
  Easier access to new markets and allow diversification into new industries or sectors by leveraging local Partners' knowledge and relationships.
- **Specialisation**
  Higher-quality outcomes, especially for entities within vertically integrated value chains as Partners can focus on their areas of specialisation.

Disadvantages

- **Shared Control**
  Decision-making often requires consensus, potentially resulting in disputes or delayed responses to market changes.
- **Potential Conflicts of Interest**
  Partners might possess conflicting objectives or interests, straining the relationship within the joint arrangement.
- **Limited Autonomy**
  The autonomy of each Partner in their respective areas of expertise may be limited.
- **Profit Sharing**
  The division of profits may not always align with each Partner's contributions or expectations.
- **Exit Challenges**
  Exiting a joint arrangement can be complex, typically necessitating consensus from all or a significant majority of the Partners involved.
- **Intellectual Property Concerns**
  Protecting intellectual property contributed to the joint arrangement can be challenging when shared among Partners.

The success of a joint arrangement relies on thorough planning, clear terms and conditions, effective communication, and alignment of goals and expectations among Partners. Whether or not to utilise a joint arrangement requires a thorough examination of all relevant factors, including the benefits and costs. This determination should be made on a case-by-case basis.

How does the accounting standard prescribe joint arrangements?

Joint arrangements are prescribed by HKFRS 11, they are classified into two distinct types and with very different accounting treatments.

Joint venture

A joint venture typically involves the formation of a distinct legal entity, with each party holding an ownership interest. The Partner uses the equity method to account for its investment in a joint venture.

One line share of results on profit or loss and share of net assets on statement of financial position

If an investment is qualified as a joint venture, its financial performance and position will not undergo detailed (line-by-line) consolidation in the Partner's financial statements. Instead, its performance is reported under the share of the result of the joint venture while its position is included under interests in the joint venture in the primary statements as if a one-line consolidation. This exemplifies the application of the equity accounting method employed for the joint venture arrangement by sharing net return, and net assets or liabilities.

Ring-fencing structure

One of the key features of a joint venture would be the ring-fencing. The joint venture occurs through the establishment of a distinct legal entity, that exemplifies a ring-fencing structure, delineating asset ownership and liability obligations of the Partners from the joint venture, shielding the Partners from undue financial obligations beyond their investments. It is a protective measure to mitigate risks and ensure transparency and accountability within the joint venture structure. Should the joint venture incur any debts or legal obligations, the Partners typically hold no responsibility beyond their respective investments.

Moreover, joint venture structure helps promote transparency and clarity in operations by establishing distinct management teams and staff dedicated to its functioning. It ensures a clear delineation of responsibilities, decision-making processes, allocation of resources and prevents conflicts of interest, and facilitates effective governance.

Overall, joint venture structure helps protect the interests of Partners, providing a clear framework for operations while safeguarding assets and limiting liabilities.

Joint operation

A joint operation is a contractual arrangement in which the parties involved agree to manage specific activities or projects jointly, sharing the assets, liabilities, revenues, and expenses without forming a distinct legal entity. In a joint operation, each party retains control over their designated areas of responsibility, assets and liabilities, sharing returns based on the predetermined framework.

Line-by-line share of income, expenses, assets and liabilities as agreed

Under joint operation, each Partner recognises in its financial statements the assets, liabilities, revenues, and expenses shared from the joint operation according to the sharing mechanism sets out in the joint arrangement and complies with all relevant accounting standards. This accounting method combines the financial statements of the Partner with its share of the joint operation's details line-by-line.

In essence, joint operations enable Partners to collaborate towards achieving specific shared objectives in a project manner.

Identification of a joint arrangement

The differentiation between a joint venture and a joint operation primarily involves examining specific features as below. Thoroughly assessing these criteria helps differentiate between joint ventures and joint operations, as the classification significantly influences financial disclosures and their associated implications.

The structure of the joint arrangement

Whether it's established through **a separate legal entity**, plays a pivotal role in its classification.

It is an initial indication that the joint arrangement might be a joint venture. If there's no distinct legal entity, it won't qualify as a joint venture and automatically falls into the joint operation classification given joint control exists. However, if there exists a separate legal entity, a thorough assessment is necessary to determine whether it qualifies as a joint venture or joint operation.

A separate legal entity?

The legal and contractual framework

The **direct allocation of rights (assets) and obligations (liabilities)** through the legal framework or contractual terms significantly impacts the classification. In certain circumstances, if the Partners use the contractual arrangement to reverse or modify the rights and obligations inherent by the distinct legal form of the investee, resulting in each Partner having a specific stake in its assets and liabilities, instead of sharing the overall net assets, this could lead to a lack of distinct separation between the Partners and the investee. The modification may result in the arrangement being classified as a joint operation.

Direct allocation of assets and liabilities?

Additional facts and circumstances

When a separate legal entity exists with a clear segregation of assets and liabilities between the Partners and the investee, other factors come into consideration. These factors include examining the investee's outputs sold, its ability to sell to external parties beyond the Partners involved, pricing agreements between Partners and the investee, and the investee's business model. The purpose of considering these is to determine if, even though the legal structure and contractual agreement suggest that the arrangement is a joint venture, are there **any additional facts and circumstances that grant the Partners the majority of the economic benefits associated with the investee** or make the investee reliant on the Partners for continuously settling its obligations which might impact the classification.

Other implications

Classifying a joint arrangement as a joint venture necessitates employing equity accounting methods, resulting in a more concise presentation of the joint venture's financial performance and position in the financial statements. Could this compromise transparency or affect the clarity for stakeholders?

In some instances, establishing a joint venture might be perceived as a strategic move to optimise the financial statements by transferring both assets and more importantly, the liabilities to the joint venture, potentially improving critical financial metrics.

Nevertheless, accounting standards ensure sufficient and appropriate disclosure catering to the stakeholders, by mandating summarised financial data for significant joint ventures, an overview of financial data for less significant ones, and their related commitments and contingent liabilities in the accompanying notes. These requirements aim to provide readers with a comprehensive perspective, facilitating their decision-making process.

Applications in CLP Group

The table below lists out various joint arrangements entered into by CLP Group:

Type of joint arrangement	Business & Background	Purpose	Benefits of the joint arrangement
Joint Venture	**Hong Kong Offshore LNG Terminal** Hong Kong LNG Terminal Limited is a collaborative effort between CLP Group and The Hongkong Electric Co., Ltd ("HK Electric") which went into operation in 2023. The entity is responsible for the development, ownership, and operation of an offshore LNG terminal within Hong Kong, providing LNG regasification services and related facilities to CLP Group and HK Electric.	Support Hong Kong's energy development and bolster the region's fuel supply stability through the introduction of a new natural gas supply source.	**Cost and risk sharing** The arrangement offers the Partners the advantage of cost and risk sharing, particularly as the development, construction, and operation of an offshore LNG terminal are new scopes of business for both Partners. By entering this joint arrangement via forming a joint venture, the Partners effectively distribute risks and resources, working together to achieve their shared objective of utilising LNG for their respective electricity generation needs.
	Apraava Energy CLP Group and CDPQ strengthened their partnership, with the Canada-based global investment group progressively increasing its strategic involvement in Apraava Energy from 40% to 50% by 2022. Subsequent to the additional 10% interest in Apraava Energy being divested to CDPQ, Apraava Energy transitioned into a Joint Venture of CLP Group.	Reflect the Partners' strategic alignment and commitment on Apraava Energy, and establish a solid base for future growth during the energy transition.	**Market expansion** The completed transaction strengthens Apraava Energy's foundation to explore opportunities arising from India's decarbonisation initiatives, expanding its business boundaries. This includes investments in renewable generation, transmission, distribution, and other customer-centric energy businesses.
Joint Operation	**Argyle Street residential project** In 2017, CLP Group and Sino Land Company Limited ("Sino Land") collaborated on redeveloping CLP Group's former headquarters at Argyle Street, focusing on residential purposes, resulting in the successful completion of the project, named St. George's Mansions, which is presently in the sales phase.	Collaboratively redevelop CLP Group's previous headquarters into a residential project for sale purposes.	**Resources and expertise sharing** This collaboration showcases the primary advantages of a joint arrangement, emphasising the sharing of resources and expertise to achieve mutual objectives. CLP Group provided the strategic land location, while Sino Land contributed extensive knowledge and expertise in property development, together with the cost for redevelopment. Through this collaborative effort, they delivered a distinctive property project catering to market demands.

Joint arrangements are common to the modern business environment, each classification carrying distinct accounting implications. These require readers of the financial statements to gain a comprehensive understanding from a thorough review, including the accompanying notes. Accounting standards serve as guardians, managing the classification of these arrangements and ensuring transparent and clear financial information for stakeholders' informed assessments.