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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting:	**20 July 2006, London**
Project:	**Short-term Convergence: Interests in Joint Ventures**
Subject:	**Indirect interest in a business (Agenda Paper 12A)**

Introduction

1. At its March 2006 meeting the Board decided that the driver for accounting by participants in joint arrangements should be their contractual rights and obligations that are created by the joint arrangement, rather than whether the arrangement is of a particular type or form. Participants should account separately for contractual rights to share in the net results or output of the arrangement's operations (indirect interests) and any contractual direct right they hold in underlying individual assets or any obligation they incur in respect of underlying liabilities (direct interests).

2. In agenda paper 12 the staff suggests that the concept of a business is a useful notion in helping identifying indirect interests in a joint arrangement. In this Appendix A the staff explains the reasons why it holds such a view.

Analysis of staff

3. The research team led by the Australian Accounting Standard Board (AASB) rejected the notion of a business arrangement, as is set out in the Exposure Draft of proposed amendments to IFRS 3 *Business Combinations* (June 2005). Instead it proposed at the

March 2006 meeting the concepts of an "integrated resource arrangement" and a "non-integrated resource arrangement" to determine the nature of the interests held by a venturer in a joint arrangement. The staff notes that a business is defined as 'an integrated set of … assets'. In accordance with the Framework (Paragraph 49-(a)) 'an asset is a resource'. Therefore, it can be concluded that a business arrangement is an 'integrated resource arrangement'. There is no need to create a different term.

4. The staff considers that it would be helpful if the terms used in IFRS 3, IAS 27 *Consolidated and Separate Financial Statements*, IAS 28 *Investments in Associates* and IAS 31 *Interests in Joint Ventures* were consistent. The acquisition of control over a business would be accounted for in accordance with IFRS 3. If the business is an arrangement under unilateral control of one participant it would be accounted for in accordance with IAS 27. If it is subject to significant influence it would be accounted for in accordance with IAS 28, and if it is under joint control it would be accounted for in accordance with IAS 31.

5. In this regard, IAS 27, 28 and 31 consistently define a subsidiary, an associate and a joint venture entity as 'something' (an 'entity') under control, significant influence or joint control. The staff suggests elaborating on the concept of 'business'. This would be consistent with how the three standards refer to IFRS 3 for accounting for an interest in a subsidiary, associate or joint venture entity on its acquisition.[1]

6. Using more consistency in terms would help to deal with direct and indirect interests in a business arrangement in order to clarify the differences in scope of IFRS 3, IAS 27, IAS 28 and IAS 31, and possible interactions arisen from an arrangement under joint control that subsequently becomes under unilateral control of one participant, or on the other way around. That is to say, a unilaterally controlled arrangement that subsequently falls under the joint control of two or more participants.

7. Furthermore, the equity method, if the Board's tentative decision finally results in an amendment to IAS 31, will be applied to both associates and joint ventures. Does it mean that an interest in an arrangement, currently classified as an associate, if it

[1] See IAS 27, paragraph 2 and IAS 28, paragraphs 20 and 23. In IAS 31 the method for accounting for an interest in a joint venture on its acquisition is set out in IAS 27 or IAS 28, depending on whether proportionate consolidation or the equity method is applied (see paragraphs 30, 33 and 40 of IAS 31). Goodwill recognition and fair value measurement on acquisition need that the subsidiary, associate or joint venture be a business. It would be interesting to assess in the future the possibility if defining an associate, a subsidiary and a joint venture consistently based on the concept of an indirect interest in a 'business'. This would need further consideration about its potential impact on IAS 27 and IAS 28, and the staff thinks this is a matter outside the scope of the short-term convergence project on joint ventures.

subsequently becomes under joint control might it be accounted for in a different way other than by the equity method?. We may also face the reverse situation, a joint venture that loses joint control is classified as being significant influence.

8. In the following paragraphs the staff explains why the concept of a business arrangement helps us in identifying an indirect interest in a joint arrangement.

9. The first question is whether an indirect interest in a joint arrangement constitutes an interest in a business under joint control. In agenda paper 12 (paragraph 18.b) we have characterised an indirect interest in a joint arrangement as an interest in the economic benefits that are expected to be generated by a group of resources intended to carry on an economic activity which participants individually do not control and are not entitled to. A participant does not have rights to individual resources but only a right to sharing in the 'net' economic benefits that are expected to be generated by the economic activities intended to be carried on by those resources.

10. In an indirect interest there are two elements present:

- A group of resources under joint control that are not controlled by individual participants.
- A result or common output (e.g. a return or lower costs) that is being produced by the economic activities intended to be carried on by that group of resources.

11. These two elements basically define what a business under joint control is. The business definition additionally requires that the group or set of activities and resources is integrated. However, this condition is implicit in the second element. For a group of resources and operations to be capable of producing a specified outcome that it is necessarily for the group to be integrated. Therefore, the staff concludes that an indirect interest in a joint arrangement satisfies the conditions to be classified as an interest in a business.

Does the Board agree?

12. The second question is whether an interest in a business arrangement under joint control necessarily means there is an indirect interest in the arrangement. In answering this question the staff acknowledges that direct interests might simultaneously exist (although this is not relevant for our question). The question considers whether an

interest in a business arrangement means there is an indirect interest in the arrangement. That some direct interests might also exist should not affect our conclusion.

13. We start by presenting the current definition of a business. This is the definition proposed in the Exposure Draft (ED) of Proposed Amendments to IFRS 3 *Business Combinations* (June 2005):

> "A business is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing either:
>
> (1) a return to investors; or
>
> (2) dividends, lower costs, or other economic benefits directly and proportionately to owners, members, or participants."

14. In a business arrangement under joint control strategic financial and operating decisions require the unanimous consent of all of its participants. However this does not lead automatically to the conclusion that all underlying assets and liabilities are under joint control. As we argue in agenda paper 12 in a joint arrangement participants might simultaneously have direct and indirect interests. And this could happen even if the arrangement includes a business.

15. A business under a joint arrangement can be organised in different ways. Participants can dedicate different types of resources to the arrangement and can engage in related party transactions with the arrangement from its initial constitution. For example, participants might provide direct financing by advancing funds, might lease assets to the arrangement under operating leases or might render services and technical assistance with resources and employees than remain under participants' unilateral control. These are direct interests participants have in the business arrangement. These direct interests should be directly recognised in participants' financial statements.

16. The question is whether having identified all direct interests an indirect interest remains. In the staff view the existence of a business is not sufficient of itself to guarantee the existence of an indirect interest.

17. According to the existing business definition in the Exposure Draft a business does not need to be self-sustaining. A business does not need to include all of the inputs or processes used in operating that business, if participants in the joint arrangement are capable of continuing to produce outputs, for example, by integrating the business with their own inputs and processes. For example, a group of assets can be regarded as a business, if participants have the intention of integrating it with their existing

operations, losing, thus, its distinct and independent existence. The Exposure Draft says "in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business". The staff acknowledges that this is more likely to happen when the business is acquired under the unilateral control of one investor. However, in a joint arrangement it might also happen that the group of assets is intended to be integrated with inputs and processes of individual participants lacking a distinct or independent existence.[2]

18. For an indirect interest to exist in a business, participants must have the intention of operating the business as a distinct business. That is to say, the participants must have the intention of operating the business as a separate business, carrying on a separate economic activity, using assets and liabilities that are under joint control, in pursuit of common objectives, in terms of a common return, lower costs or other common economic benefits. This defines an indirect interest in the group as one in which participants do not have control over underlying single assets and are not responsible for underlying liabilities; rather they have only a right to share in the net outcome expected to be generated by that business's operations.

19. Not all underlying assets and obligations involved in a business arrangement's operations necessarily form part of an indirect interest. Some shall represent direct interests that participants should recognise directly in their financial statements. However, once the assets and liabilities have been recognised by participants, participants have a residual interest in the remaining group of assets and liabilities.

20. To identify both direct and indirect interests participants should look at their rights and obligations. It is relevant to note that when the joint arrangement does not encompass a business, participants will have direct interests in the underlying assets and liabilities. This is because no common economic activities are anticipated. Each participants will

[2] As an example, two carriage entities decide to constitute a joint arrangement to acquire jointly a smaller carriage entity that has available a small fleet of trucks. The two participants have a variable seasonal demand. Their peak seasons are, however, complementary. The jointly 'acquired' entity was regularly operating as a business before having been purchased. The venturers decide to maintain the fleet and drivers. All other resources are disposed of. After the acquisition, on a staggering basis during each participant's peak season, the fleet is completely integrated with each venturer's fleet under its unilateral direction. That group of assets is a business although it does not carry on a distinct economic activity nor it has separate decision-making or own objectives. In this case participants might identify direct interests in those resources only, rather than just an indirect interest in a common outcome generated by those resources.

have direct rights to the economic benefits directly generated by individual assets and will be directly responsible for its share of the underlying liabilities.[3]

21. How direct and indirect interests are structured in a joint arrangement will vary from case by case. For example, in some jointly controlled operations participants carry out substantial parts of the operations separately with their own assets and liabilities. An example would be when several participants combine their operations and resources to manufacture and market jointly a particular product. The indirect interest might encompass the product's design, assembly and marketing of the product, whereas the different parts are manufactured by each participant separately using its own resources and employees.

Business features to represent an indirect interest

22. For an indirect interest to exist the business arrangement must have a management capacity to carry on a separate and distinct economic activity in pursuit of a common outcome through the deployment of a group of assets and liabilities that are under joint control.

23. An underlying group of assets and liabilities within the business arrangement should be effectively under joint control of all participants. If the whole group of assets and liabilities is under unilateral control of individual participants, which use such group within their own economic activities to get directly their associated economic benefits, participants shall have only direct interests in that group.

24. An example would be two farmers that acquire jointly a piece of land for developing an agriculture activity. They also acquire all the equipment and material necessary to operate the land. Each farmer grows a different product in different seasons. The products are complementary. Strategic decisions such as disposal of land, acquisition of equipment and the type of biological products to be grown are adopted unanimously. However each participant unilaterally manages those assets for its own activities with

[3] An asset is a resource from which economic benefits are expected. When participants have interests in a group of underlying assets and liabilities of a joint arrangement, they may have direct interests in single resources from which economic benefits are expected to be produced directly, or they may have an interest [indirect] in a group of them that are under joint control in a way that the economic benefits are expected to be generated not separately from each individual resource in the group but by the group itself, in terms of the common outcome produced by such a group's economic activities. If the arrangement is not a business and economic benefits are not expected from the group of resources itself, the economic benefits should be expected directly from the individual underlying resources under the unilateral control of participants. Otherwise the interest in the arrangement would not expect to generate economic benefits and would not meet the definition of an asset.

its own employees and sells and distributes its crop to the market. Participants would have direct interests only in those assets (land and equipment).

25. To be an indirect interest or a business the arrangement must be managed and operated as a distinct business. That is to say, the set of resources under joint control should have a distinct and integrated structure that is capable and intended to be separately managed in pursuit of distinct common objectives.

26. In accordance with the business definition in the ED to IFRS 3, a business should be capable of being managed for providing common objectives. However, for a business arrangement to comprise an indirect interest, participants must have decided to manage distinctly the group of assets under joint control so that participants can get benefits only from the combined resources.

27. Therefore, to be an indirect interest, the business should have common objectives as well as have some sort of operating management capacity under a distinct decision-making.[4] This is consistent with the current thinking on the conceptual framework project.[5]

28. The staff notes that common objectives complement, and are closely linked to, independent decision-making. A jointly controlled business, under a separate decision-making subject to joint control, ensures that the arrangement has distinct objectives. Distinct decision-making over the arrangement's economic activities necessarily encompasses determining its own objectives. Independent decision-making from participants generally means distinct and separate objectives from those of individual participants. An independent decision-making process over the arrangement's economic activities needs, and leads to, its own objectives to be pursued.

29. So, if the business is carrying on a separate economic activity under a separate decision-making process, using resources under joint control in pursuit of common

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[4] These elements are necessary to make it sure the arrangement has its own visible boundaries. Otherwise the business would lose its own decision-making identity and the arrangement would act as a mere agent of participants in the pursuit of participants' individual objectives rather than common objectives of all participants. This situation leads to direct rather than indirect interests in the arrangement.

[5] In Agenda Paper 2B *Conceptual Framework Reporting Entity: Preliminary Staff Research* presented to the Board in December 2005 a possible connection is mentioned between the concepts of entity and business. In the paper is said that that "a 'business' is not, in itself, an 'entity'. Rather, it is stated that for a business being considered an entity, an arrangement must be capable of performing in some manner. Under that approach for something to be an entity the business should be part of an organisation or structure that has some sort of operating capacity or ability to act. This ability might be established, for example, by the presence of people who conduct or manage the business (see paragraphs 85-87 of the mentioned paper). See also Agenda Paper 3 *Conceptual Framework-Reporting Entity*, IASB March 2006 meeting.

distinct objectives, participants will have an interest in the arrangement as a whole, and their rights will be primarily referred to the common 'resource' with ability to produce future benefits to them. Using the definition of an asset, the lowest level of assets that a participant could be said to hold and control is its net interest in the group of assets and liabilities.