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International Accounting Standards Board

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INFORMATION FOR OBSERVERS

Board Meeting: **March 2006, London**

Project: **Joint Ventures Research Project - Paper I: The Classification of Joint Arrangements (Agenda Paper 9B)**

Abstract:

This paper considers some scenarios involving joint arrangements with a view to identifying bases on which a meaningful classification for accounting purposes can be made. It classifies joint arrangements into two types:

(1) Non-integrated resource arrangements in which the participants continue to hold direct rights in assets contributed and assume direct responsibilities for obligations arising from the joint economic activity. In this case, each participant primarily pursues its own economic activity within the arrangement to achieve its own specific objectives.

(2) Integrated resource arrangements, where rights in assets and responsibilities for liabilities reside with the joint arrangement itself, which utilises them to achieve its own separate objectives. The arrangement is a separate entity carrying on an economic activity of its own. It has a separate decision making identity.

The paper notes that non-integrated resource arrangements often do not present any special accounting problems, although specific accounting requirements may need to be promulgated in respect of such arrangements to enhance comparability. This may involve no more than clarifying in the joint ventures accounting standard that participants' direct interests are to be accounted for in accordance with other particular standards.

Distinct Categories of Economic Activities

1. Joint arrangements carrying on economic activities may be classified into the following two types.

   (i) Non-integrated resource arrangements

   (ii) Integrated resource arrangements

2. A non-integrated resource arrangement is an arrangement that:

   (a) involves the deployment of resources contributed by participants for joint economic activity in such a manner that participants continue to hold direct rights in the assets contributed and assume direct responsibilities for obligations arising from the joint economic activity;

   (b) is not an entity[1] separate from its participants; and

   (c) primarily pursues individual objectives of participants, rather than its own separate objectives.

3. Therefore, a non-integrated resource arrangement is not an entity carrying on an economic activity of its own. To carry on an economic activity of its own, an entity uses its own assets and liabilities to achieve its own separate objectives.

4. Non-integrated resource arrangements often exhibit one or more of these characteristics:

   (a) The participants seek to further their own economic activities through the joint arrangement. Each participant progresses its own economic activity independently of other participants in the structure. Accordingly, the activities

1 In this paper and Paper II, the term "entity" means "any legal, administrative, or fiduciary arrangement, organisational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve objectives", unless otherwise indicated. That is the definition of an entity in Australian Statement of Accounting Concepts SAC 1 *Definition of the Reporting Entity*, paragraph 6. An entity need not be constituted as a separate legal entity. This feature of an entity is compatible with IAS 31 *Interests in Joint Ventures*, in which paragraph 24 notes that "A jointly controlled entity is a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest". IAS 32 *Financial Instruments: Disclosure and Presentation*, paragraph 14, notes that "In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies." There is some discussion of an entity in FASB literature. For example, FASB Concepts Statement No. 6, *Elements of Financial Statements* states that "All elements are defined in relation to a particular entity, which may be a business enterprise, an educational or charitable organization, a natural person, or the like….An entity may comprise two or more affiliated entities and does not necessarily correspond to what is often described as a "legal entity."…" (Concepts Statement No. 6, paragraph 24).

progressed within the arrangement can be identified as an extension of each participant's economic activity.

(b) The arrangement is an agent of participants, that is, the arrangement's role is that of a manager of the assets and liabilities on behalf of the participants. The arrangement acts as the conduit for passing on expenses and revenues to the participants.

(c) The participants use their own resources, incur their own expenses and liabilities and raise their own finance.

(d) The activities of the arrangement are carried out by the participant's employees alongside the participant's similar activities.

(e) The arrangement does not have its own separate objectives.

(f) It is often possible to segregate the activities of the arrangement so that each participant's results can be separately identified.

(g) The arrangement does not constitute a decision-making identity separate from participants.

This list is not intended to be exhaustive.

5. An integrated resource arrangement is a joint arrangement that:

(a) involves the integration of resources contributed by participants for joint economic activity in such a manner that the arrangement holds direct rights in, and is directly responsible for, the assets contributed to and obligations arising from the economic activity progressed within the joint arrangement;

(b) is an entity separate from its participants; and

(c) primarily pursues its own separate strategic objectives.

6. Therefore, an integrated resource arrangement is an entity carrying on an economic activity of its own. To carry an economic activity of its own, an entity uses its own assets and liabilities to achieve its own separate objectives.

7. Integrated resource arrangements exhibit the following characteristics:

(a) The arrangement controls the resources in its own right and not on behalf of the participants.

(b) Participants do not control or jointly control the individual assets of the arrangement; rather, they control an interest in the arrangement (an investment).

(c) The arrangement carries on an economic activity that is separate from the activities of its participants.

(d) The arrangement has its own separate objectives.

(e) The arrangement has a separate decision-making identity.

This list is not intended to be exhaustive.

Non-integrated resource arrangements

8. Examples of non-integrated resource arrangements are arrangements known as ‘contracting companies’ or ‘joint bidding companies’. A company is formed to tender on the basis that performance of work will be apportioned among the participant contractors. The company is managed by each participant carrying out its normal activities. By tendering as a company, each participant is protected against unlimited losses resulting from non-performance of other participants but gains the benefits of tendering with others, as illustrated in Scenario 1.

Scenario 1

Company X is formed by Companies A and B specifically to tender for contracts for the supply and installation of road barriers. Company A supplies the barriers and Company B installs them. If the parties were to tender individually, each would be required to extend its operations to supply the product or service it does not currently provide. Company X formalises a contractual arrangement that preserves the respective specialisations of each participant. Company X then contracts with A and B to complete performance. X does not earn a profit; rather, profit is earned by the individual participants in contracting with X. The assets and liabilities of X consist of a receivable, resulting from outstanding payments from the client, and payables to the participants for the work they perform or materials they supply.

In the above illustration, the joint arrangement is a vehicle to facilitate bidding for contracts that participants could not individually bid for. The resources of A and B are in substance non-integrated since services are effectively delivered individually, although they are provided through a separate company.

9. Many joint arrangements referred to in IAS 31 as joint operations also represent non-integrated resource arrangements. In such operations, each participant uses its own resources (such as property, plant and equipment and inventories), incurs its own expenses and liabilities and raises its own finance. The joint operation may be carried out by the participant's employees alongside the participant's similar activities. The contract specifies the proportion in which the outputs, or revenues from their sale, are allocated and how common expenses are shared. In such arrangements, participants often combine their operations, resources and expertise to manufacture, market and distribute jointly a particular product.

Scenario 2

Company A is a manufacturer of diesel engines and Company B designs and produces automobile bodies. A and B enter into a joint arrangement with Company C to produce a passenger transporter designed specially for a foreign market. Company C produces the chassis for light transport vehicles. The manufacturing process is shared by the participants, each controlling its resources deployed in producing the respective part of the transporter. Each participant bears its own expenses and takes a share of the revenue from the sale of the product, such share being determined in accordance with the contractual arrangement.

10. There are no particular joint venture accounting issues in regard to arrangements of the types depicted in Scenarios 1 and 2, as each party would reflect its assets, liabilities and expenses and its share of the arrangement's revenues in its financial statements.

11. Another example of a non-integrated resource arrangement is a joint arrangement that shares costs and revenues and in respect of which the participants continue to hold direct rights in assets contributed and to be responsible for liabilities arising from the joint economic activity. Under these arrangements, each of the assets of the arrangement may be held by participants as undivided interests (see paragraph 12) and each of the liabilities may be held as joint and several liabilities.

Scenario 3

Entities A and B enter into a joint arrangement for extracting gold from a mine. Each holds an undivided interest in the mining property, buildings, equipment, working capital and other resources used in the extraction process. A and B assume joint and several responsibility for any liabilities. Entity A is appointed as the operator, and costs and revenues are allocated to participants for net cash settlement.

12. One legal form of a jointly controlled asset is an undivided interest in a property. An undivided interest may be defined as "an ownership interest in which two or more parties jointly own property in which title is held individually to the extent of each party's interest"[2]. A jointly controlled asset is a non-integrated resource arrangement. It is generally unincorporated but it may be established in an incorporated form. In the latter case, the substance differs from its legal form since participants continue to hold direct rights in the underlying assets despite the existence of a separate legal entity.[3] The implications of undivided interests are discussed in paragraphs 15-20.

13. Another variant of Scenario 3 above is the introduction of a company or a trust into the arrangement:

Scenario 4

A and B enter into joint arrangement for extracting gold from a mine. They set up a company to manage the assets and liabilities of the mine on behalf of participants. A is appointed as the operator, with all costs, revenues, gains and losses passed through to participants as in Scenario 3.

In Scenario 4, although another entity holds assets and liabilities on behalf of A and B, the substance of the arrangement is the same as in Scenario 3, that is, it is a cost and revenue sharing arrangement with participants having direct rights in assets and being responsible for liabilities. The formation of the company is for the management of assets and liabilities on behalf of the participants, and the company as an agent of participants is the conduit for passing on expenses and revenues to the participants.

14. Scenarios 3 and 4 are simple representations of joint arrangements that involve the joint ownership of a single asset or several assets. In these arrangements, each participant has an undivided interest in each of the assets used in the joint activity.

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2 American Institute of Certified Public Accountants, Accounting Standards Executive Committee, Issues Paper, Joint Venture Accounting (New York: AICPA, July 1979), par. 3. For a discussion of 'undivided interests' see also Paper IV, Section 6.

3 In some cases, laws or side contracts require participants to hold direct rights. As for liabilities, although they are the liabilities of the incorporated entity, participants can by contract agree to automatically compensate the company based on cash calls it makes on participants in regard to the extinguishment of such liabilities.

This situation frequently occurs in the oil and gas industry when two participants enter into a joint arrangement that owns only a working interest in an oil and gas property. The working interest represents an undivided interest in the property and the participants are responsible only for their share of any liabilities from that property. Under this structure, each participant will fund its share of the cost required to operate the property and will then take physical delivery of a share of the produced oil or gas for use in its downstream operations for sale, based on its individual infrastructure. Paper IV "The Structures of Joint Ventures" discusses the structure of undivided interests. The following paragraphs discuss the nature of rights to economic benefits represented by undivided interests.

Nature of Assets Arising From Undivided Interests

15. Conceptual frameworks provide a reasonable basis for identifying the asset(s) a participant should recognise in its financial statements in respect of its undivided interest in a resource. For example, the IASB Framework provides the following:

> "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity"[4].
>
> "Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity"[5.]

16. Similarly, FASB Statement of Financial Accounting Concepts No. 6 states[6]:

> "The definition of assets focuses primarily on the future economic benefit to which an entity has access and only secondarily on the physical things and other agents that provide future economic benefits. Many physical things and other agents are in effect bundles of future economic benefits that can be unbundled in various ways, and two or more entities may have different future economic benefits from the same agent at the same time or the same continuing future economic benefit at different times. For example, two or more entities may have undivided interests in a parcel of land. Each has a right to future economic benefit that may qualify as an asset under the definition in paragraph 25, even though the right of each is subject at least to some extent to the rights of the other(s)."…

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4 Framework, paragraph 49(a).

5 Framework, paragraph 56.

6 FASB Statement of Financial Accounting Concepts No. 6 "Elements of Financial Statements", paragraph 185.

Since the owner of a proportionate interest has legal title to its share of any production, has the ability to sell or refinance its interest, and controls who is entitled to the production from its portion of the asset, an undivided interest in a resource can be recognised as an asset by its holder.

Componentisation

17. The conceptual framework extracts quoted in paragraphs 15 and 16 suggest that a component of a resource can be an asset. Whilst a resource might be composed of separately identifiable physical components, future economic benefits arising from a resource can also be subdivided into components in other ways. For example, they can be subdivided:

(a) by reference to the time that the resource is made available to an entity (for example, an exclusive right to use a resource for five days a week);

(b) by reference to the capacity of the resource to generate benefits (for example, an exclusive right to use 50 percent of the capacity of an oil pipeline); and

(c) by reference to the output arising from the resource (for example, an exclusive right to 75 percent of the output of a power plant)[7].

18. Accordingly, an undivided interest is seen as a separate right to some of the economic benefits provided by a physical resource, rather than an interest in that physical resource[8]. That is, the interest of a participant in a physical resource need not be separately functional to qualify as an asset. An undivided interest in a resource (pro rata or non-pro rata[9]) is recognised as an asset when the IASB Framework's asset recognition criteria are satisfied, that is, it is probable that the future economic

7 IFRIC Draft Interpretation, 'Determining Whether a Contract is a Lease', quoted in FASB EITF Issue No. 01-8, Working Group Report No. 3 'Determining Whether an Arrangement Is a Lease', September 4, 2002, paragraph 9.

8 The UK Accounting Standards Board's Statement of Principles explicitly indicates that possession of ownership rights is not essential to meet the definition of an asset. It states: "An asset is not the item of property itself, but rather the rights or other access to some or all of the future economic benefits derived from the item of property." (Statement of Principles, paragraph 4.8).

9 In case of tangible assets, such as property, plant and equipment, where the undivided interest holder has a non-pro rata interest, it may be in a position to control the use of a portion of the asset that has separate functionality from the entire asset or may control the entire asset for a specific period of time. For example, an undivided interest in a duplex apartment building may give the interest holder the right to reside in one apartment for a period of time or in perpetuity (thus providing the interest holder control over the use of that apartment on a non-pro rata basis). Similarly, an undivided interest in manufacturing equipment may allow the holder to operate the equipment for its own use and benefit for one day of each week (thus providing the interest holder control over the use of that equipment on a non-pro rata basis).

benefits will flow to the entity and the asset has a cost or value that can be measured with reliability. Making undivided interests, rather than physical resources, the subject of recognition is consistent with the contractual rights and obligations model adopted by this project.

19. Based on the arguments made in paragraphs 17 and 18, joint arrangements that involve undivided interests do not present any special accounting problems. Generally, methods promulgated by standards other than those applying to joint ventures, and the application of principles set out in conceptual frameworks, provide a reasonable basis for the recognition and measurement of assets, liabilities[10], revenues and expenses and disclosure of items such as cross guarantees and contingencies associated with such arrangements. For example, in scenarios 3 and 4 above, participants A and B would each reflect their undivided interests in the resources and their share of the liabilities in their financial statements, and recognise the revenues and costs as an extension of their other operations. A and B would also be expected to disclose the joint nature of these assets and liabilities, and any contingent liabilities.

20. This paper argues that non-integrated resource arrangements – whether in the form of quasi-contracting arrangements, cost and revenue sharing arrangements, undivided interests or similar arrangements – do not present specific accounting problems per se. However, it also acknowledges that there are generally established industry practices in some jurisdictions that deal with interests in such arrangements. Although the existence of such practices shows that affected industries have been able to regulate the accounting for such arrangements using general accounting principles, the diversity of such practices may have led to reduced comparability in presentation and disclosure in the financial statements across such industries and jurisdictions. As such, it may be necessary to promulgate accounting requirements to enhance the comparability of financial information in relation to non-integrated resource arrangements.

Integrated resource arrangements

21. In an integrated resource arrangement, the resources of different participants are integrated in such a manner that the arrangement is a separate entity carrying on an economic activity of its own. In such cases, the joint arrangement has a strategic decision-making identity separate from the participants, referred to as "separate

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10 Subject to considerations in footnotes 3 and 5 above relating to the effect of form on substance.

decision-making identity"[11]. A "separate decision making identity" exists when strategic policy decisions are made for the arrangement as a whole.

22. In Scenario 4 above, although a company was formed to progress the joint activities of A and B, the company does not have a separate decision making identity because it does not have the characteristics of an integrated resource arrangement. A rewrite of Scenario 4 to depict an arrangement that has a separate decision-making identity is as follows:

> ***Scenario 5***
>
> A and B enter into a joint arrangement structured as a company for extracting gold from a mine. Their holdings in the company are equal. The company controls resources contributed by participants and is liable for obligations arising from the joint economic activity progressed within the arrangement. The company signs contracts with each of A and B under which each commits to acquire specified amounts of the output of the mine at a fixed price under a take-or-pay arrangement. A and B are entitled to their pro rata share of the net profits or losses of the company.

In this Scenario, unlike Scenario 4, the company controls the resources in its own right and not on behalf of the participants. It uses them for the objective of generating economic benefits in the form of profits. Thus, the assets that A and B control are interests in the company and not individual assets used in the company's operations, and the company is an entity that pursues an economic activity that is separate from the economic activities of its participants. It has a separate decision-making identity.

11 'Separate decision making identity' is discussed in Paper II, The Definition of a Joint Venture, paragraphs 47-52.

Conclusions and recommendations

24. Joint arrangements may be classified into two types. In the first type, called non-integrated resource arrangements, the participants continue to hold direct rights in assets contributed and assume direct responsibilities for obligations arising from the joint economic activity. In this case, each participant primarily pursues its own economic activity within the arrangement to achieve its own specific objectives. In the second type, assets and liabilities reside with the joint arrangement itself, which utilises them to achieve its own separate objectives. The arrangement is a separate entity carrying on an economic activity of its own. It is a separate decision making identity.

25. Non-integrated resource arrangements do not present any special accounting problems. Each participant would use methods promulgated by standards other than those applying to joint ventures and would apply principles set out in conceptual frameworks for the recognition and measurement of assets, liabilities, revenues and expenses. However, separate disclosure requirements may need to be specified regarding the items associated with such arrangements. In addition, due to the diversity of practices across industries and jurisdictions in relation to investments in non-integrated resource arrangements, accounting requirements in respect of such arrangements may need to be promulgated to enhance comparability of financial information. This may involve no more than clarifying in the joint ventures accounting standard that participants' direct interests are to be accounted for in accordance with other particular standards.