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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting:	**19 April 2007, London**
Project:	**Short-term convergence: Joint Ventures**
Subject:	**Drafting of proposed amendments to IAS 31 including illustrative examples (Agenda Paper 9)**

Introduction

1. The purpose of this education session is twofold:
   a. First, to walk through the approach that we have taken in drafting the proposed amendments to IAS 31 *Interests in Joint Ventures*.
   b. Second, to walk through illustrative examples that demonstrate the application of the Board's decisions regarding the definition of a joint venture.
2. We seek the Board's input on whether:
   a. the drafting approach is appropriate,
   b. the examples are those that should be included in the exposure draft,
   c. our analysis of the examples reflects the Board's decisions, and
   d. our analysis of the examples is consistent with the proposed amendments to IAS 31.
3. [This paragraph is not reproduced in the observer notes].
4. The paper is structured as follows:
   a. Summary of the Board's tentative decisions (paragraph 5).

b. Analysis of the changes in terminology proposed by the staff as a consequence of drafting the amendments (paragraph 6).

c. Synopsis of the proposed amendments (paragraphs 8 to 12).

d. Illustrative examples (paragraphs 13 and IE1 to IE57).

e. Appendix: 1st draft of proposed amendments to IAS 31. [The appendix is not reproduced in the observer notes].

Tentative decisions – a summary

5. At its December 2005, and March and July 2006 meetings, the Board made the following decisions regarding the short-term convergence project on joint ventures:

   a. to remove the option of accounting for jointly controlled entities using proportionate consolidation.

   b. that the driver for accounting by parties to joint arrangements should be their contractual rights and obligations that are created by the arrangement, rather than whether the arrangement is of a particular type or form.

   c. that a venturer should classify its interests in joint arrangements as either:

      i. direct interests in underlying single assets or liabilities, whereby venturers have rights to individual assets or direct obligations for individual liabilities, or a share of them, within the group of assets or liabilities; or

      ii. an indirect interest in the ‘net’ outcome expected to be generated from a group of underlying assets and liabilities under the joint control of all of the venturers.

   d. that a venturer would recognise its direct interests in assets and liabilities in accordance with applicable standards. A venturer would recognise its indirect interest in a joint venture using the equity method.

   e. that an interest in a jointly controlled business would represent an indirect interest in a joint venture, in the absence of circumstances indicating otherwise.

Terminology

6. We set out to draft the amendments with the following constraints in mind:

   a. a fundamental change to the wording of the standard might imply that we are changing the accounting for all joint arrangements subject to the requirements of IAS 31, which is not the case. For example, we expect little change to the accounting for jointly controlled operations and jointly controlled assets.

b. much of the wording of IAS 31 remains relevant and should be retained in the amended standard. For example, the descriptions and accounting for jointly controlled operations and jointly controlled assets is retained largely unchanged.

c. this is a short-term project, and thus, there is an expectation that the standard would not change dramatically.

7. It became clear to the staff during drafting that there are difficulties amending IAS 31 using the wording of the Board's tentative decisions (ie, introducing the classification of a venturer's interest in a joint arrangement as *direct* or *indirect*). Drafting in this format did not work because:

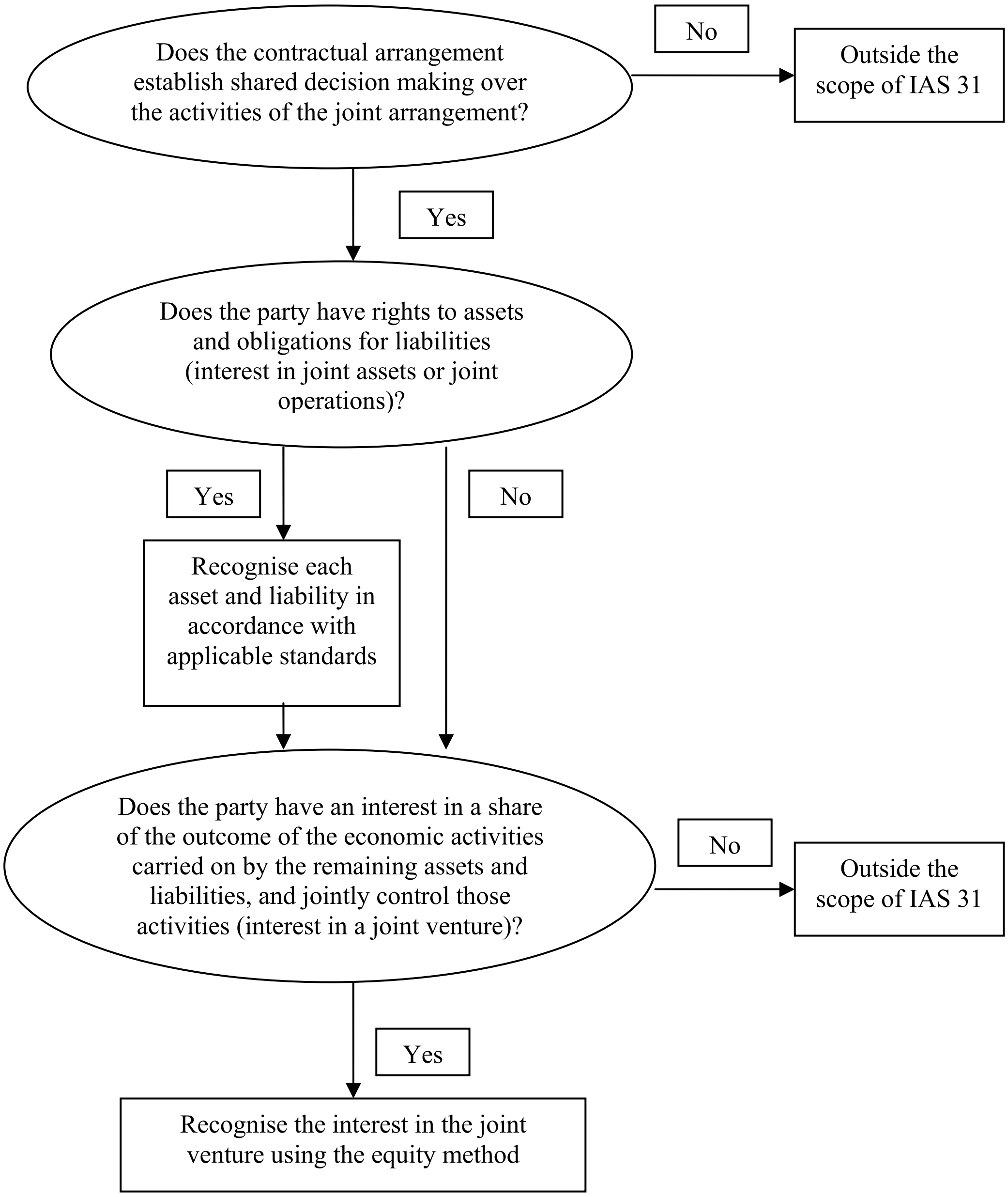
a. IAS 31 is structured around the three forms of joint ventures identified in the standard—jointly controlled operations, jointly controlled assets and jointly controlled entities. It proved difficult to introduce the classification of a venturer's interest as direct or indirect whilst retaining the descriptions and requirements for the three forms of joint venture.

b. although the terms 'direct' and 'indirect' were helpful in developing the thinking for joint arrangements, they do not work well in the standard itself. A party to a joint arrangement will normally have a direct interest in an asset, operations or a joint venture entity. It is the latter that creates confusion. The venturer has an indirect interest in the assets and liabilities of the venture but a direct interest in the venture itself. The objective of the proposed amendments to IAS 31 is to ensure that whatever the venturer has a direct interest in is accounted for appropriately.

Synopsis of the proposed amendments

8. This section of the paper explains how the staff has prepared the 1st draft of proposed amendments to IAS 31. The 1st draft is attached in an appendix to this paper.

9. The following flow chart illustrates how a party to a joint arrangement recognises its interests in the arrangement. It gives an overview of the drafting of proposed amendments to IAS 31.



10. The accounting for interests in joint arrangements is driven by the contractual rights and obligations of the parties to the arrangement (Board decision in March 2006). This decision has been drafted as follows:

a. The contractual rights and obligations of the parties that arise from the contractual arrangement determine the type of joint arrangement—joint operations, joint assets or joint venture.[1]

b. If a party has rights to assets or obligations for liabilities, the joint arrangement involves joint operations or joint assets. A party accounts for its interests in joint assets and joint operations in accordance with applicable standards.

[1] The changes to the definitions and terminology in IAS 31 are explained in paragraphs 11 to 12.

c. If a party has rights only to a share of the outcome generated by the economic activities of the arrangement, the joint arrangement is a joint venture. A party accounts for its interest in a joint venture using the equity method.

d. The 1st draft notes that a party to a joint arrangement could have rights to some assets or obligations for some liabilities, and also have an interest in a joint venture that controls the remaining assets and has obligations for the remaining liabilities. We have included examples to illustrate this (examples 3 and 4 in paragraphs IE15 to IE36 of this paper). From discussions with preparers in October and November 2006, we expect the vast majority of joint arrangements to be either joint ventures, joint operations or joint assets and not a combination of any two of these.

e. The Board's decisions regarding a jointly controlled business have been included within the description of a joint venture. We have also included additional guidance regarding the nature of a party's interest in joint assets within the description of joint assets.

f. The staff thinks that the short-term project on joint ventures is an opportunity to incorporate SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers* into IAS 31. The conclusions reached in SIC-13 are included in IAS 31 as paragraphs 48A to 48C (refer to 1st draft of proposed amendments to IAS 31 in the appendix to this paper).

Changes to definitions and terminology

11. The definitions and terminology used in IAS 31 are changed in the following ways:

a. Because the contractual rights and obligations of a party to an arrangement determines the accounting, rather than the legal form of an arrangement, a jointly controlled entity is no longer identified as a form of joint arrangement that requires a particular accounting treatment. Instead, those arrangements in which the parties have an interest only in their share of the outcome of the activities, and over which the parties have joint control, are known as 'joint ventures'.

b. Consequently, 'joint venture' is no longer used to describe all forms of joint activities subject to the requirements of IAS 31. The definition of a joint venture in IAS 31 refers to the venturers having joint control over the activities of the venture. Joint control remains as part of the definition of a joint venture in the proposals. However, 'joint arrangement' is used to describe all forms of joint activities subject to the requirements of IAS 31. The definition of a joint arrangement refers to shared decision making rather than joint control.[2]

c. 'Joint control' has been removed from the descriptions of joint operations and joint assets. Joint operations and joint assets are now described as being subject to shared decision making rather than joint control, as defined in IFRS (refer to paragraph 12 for a discussion of joint control). Therefore, the titles 'jointly controlled operations' and 'jointly controlled assets' have been changed to 'joint assets' and 'joint operations'.

12. The reasons for changing the definitions and terminology are as follows:

a. Control is defined in IAS 27 in the context of controlling an entity ['control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities']. Joint control is an extension of that definition ['joint control is the contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control']. Joint control can, therefore, only exist if there is a separate business or economic activity over which the parties to the arrangement share the power to govern its financial and operating policies. This is so when the joint arrangement is a joint venture.

b. The special meaning that 'control' has within IAS 31 (from IAS 27) means that it is difficult to use the term with the more general meaning used in the *Framework* [Paragraph 49(a)] in relation to assets and operations. That is to say, the definition of control in IAS 27 was developed with an entity in mind and that definition does not transfer easily to assets or operations. To illustrate, if two parties acquire an asset jointly but make their own arrangements for financing the acquisition, it is arguable that the asset does not have any financing policies that could be the subject of joint control. Therefore, rather than using the term 'control' we have suggested that the sections on assets and operations refer to 'shared decision making'. This change should also address the following concerns:

   i. An entity cannot *share* control of (or jointly control) an asset. The definition of an asset in the Framework requires an entity to control an asset ["an asset is a resource controlled by an entity…" (paragraph 49)]. Whilst an entity cannot share control of an asset, it can control part of a single economic

[2] A joint arrangement is defined as a contractual arrangement whereby two or more parties undertake an economic activity together and share some or all of the decision making relating to that activity.

resource and would recognise that interest as an asset in its financial statements (for example, an entity might jointly own and control its rights to a share of a building or a piece of land). Similarly, an entity cannot have a shared obligation, but can have a liability for a share of a single obligation.

ii. In joint operations, the parties to the arrangement use their own assets and have present obligations for their own liabilities—the only element of the operations that is joint or shared might be the marketing and revenue stream. It is unlikely that the parties to the arrangement would establish financial and operating policies relating to the activities that are subject to the joint control arrangement.

Illustrative examples

13. The following paragraphs detail the examples that we propose to include as illustrative examples accompanying the proposed amendments to IAS 31. The staff seeks input from the Board on whether the examples used and the staff analysis appropriately illustrate the decisions of the Board.

Example 1: Joint operations

IE1 Companies A and B form a company, C, to tender for a public contract with a government to construct a motorway between two cities. A and B share decision making over the activities of C.

IE2 A will construct three bridges needed to cross rivers on the route; B will construct all of the other elements of the motorway. A and B will each use their own equipment and employees in the construction activity.

IE3 C enters into a contract with the government for delivery of the motorway. It also enters into a contract with A and B for performance of the government contract. A and B will invoice C for their respective shares of the total amount invoiced by C to the government.

Analysis

IE4 The arrangement is a joint operation, formed to facilitate bidding for a contract that the parties could not individually bid for. A and B have retained control of the assets they use to perform the contract requirements and are responsible for their respective liabilities. They meet their respective contractual obligations by providing services to C.

IE5 A and B recognise in their financial statements the property, plant and equipment and operating assets that they control and their share of any liabilities resulting from the joint arrangement (such as performance guarantees).

IE6 They also recognise their interest in C using the equity method. It is likely that their interests in C would be nominal because C does not have any activities other than the contract with the government and the service agreements with A and B.

Example 2 – Joint interest in an asset

IE7 Five advertising companies (the parties) purchase jointly a jet airplane. They enter into an agreement whereby each party has the right to use the airplane for their own purposes some days each year. The parties may decide to use that right, or, for example, lease it to a third party. The parties share decision making regarding maintenance and disposal of the airplane. These decisions require the agreement of all of the parties.

IE8 Each party is able to sell its interest to a third party, with the approval of the other parties. The agreement covers the expected life of the jet and can only be changed if all of the parties agree. The residual value at the end of its useful life is nominal.

Analysis

IE9 The parties each control a share of a joint asset, the jet airplane. The joint arrangement is a way to share the costs of having access to an airplane; its purpose is not to generate profits from a separate economic activity. Each party has a unilateral right to use the airplane for its own purposes some days each year and it is this right that is the asset each party controls.

Variation - the asset is transferred to an entity

IE10 Continuing the example, suppose the parties set up a company to purchase the jet airplane. The airplane is purchased in the name of the company, financed by cash contributions made by the parties. Any strategic operating and financing decisions made by the company require the agreement of all shareholders.

IE11 The parties also enter into an operating agreement with the company that gives the parties the same rights to the airplane as in the original example. That is to say, the same rights of use. The operating agreement also includes the same maintenance and disposal powers as in the original example. To be a party to the agreement it is necessary to be a shareholder in the company.

IE12 A party can sell its interest in the airplane by selling their shares in the company. The same restrictions on sale exist as in the original example (ie that all of the parties must approve the sale). Any new shareholder becomes a party to the operating agreement.

Analysis

IE13 The modification to the example should have little impact on the accounting by the five advertising companies. The operating agreement ensures that the parties each have the same rights of use as in the original example. Each party would recognise its rights to the jet airplane.

IE14 What is different is that the parties also have an interest in the company. The company has legal ownership of the airplane, although the rights of use have been transferred to the parties. The company structure might affect the responsibilities of the parties, by providing a liability shield. Each party would recognise its interest in the company using the equity method, which is likely to be nominal given the nature of the operating agreement.

Example 3 – Jointly held asset

IE15 Two entities (the parties) acquire a shared interest in land. The purpose of the investment is capital appreciation. The sale or disposal of the land requires the consent of both parties. Each party has the right to sell its interest in the land to a third party, although the other party has pre-emptive rights to that interest.

Analysis

IE16 The arrangement involves a joint asset. Each party controls its access to the economic benefits derived from its interest in the land by either selling its share to another party or waiting for the land to be sold on agreement by the other party. Decisions about the sale of the land require the consent of both parties. This does not change the fact that the parties have an interest in the land, although it could affect the value of that interest.

IE17 Each party recognises their interest in the land.

First variation - the asset is transferred to an entity

IE18 Suppose that the parties each transfer the legal ownership of the land into a company. The land cannot be sold by the company without the consent of both parties (as shareholders). Each party has the right to sell its shares in the company, although the other party has pre-emptive rights to the shares.

Analysis

IE19 In this case, the arrangement involves a joint venture. Each party has exchanged its interest in the land for an interest in the company. The parties have contractual rights to their shares in the company, but not directly to their share of the land.

IE20 This example is different from the variation in example 2, involving the jet airplane. In that example the parties have rights to use the asset, and those rights are recognised in the financial statements of each party. In this example, the parties do not have rights to use the land; they have rights relating only to their shareholding in the company.

IE21 The parties recognise their interest in the company using the equity method. Because the rights to the land sit inside the company, there will be a difference in the nature of the asset reported by the parties.

Second variation – the rights of use are contracted out of the company

IE22 Continuing the example, suppose that the parties contract with the company giving each party the right to use the land for six months each year for whatever purpose they wish, within constraints established by the agreement. For example, a party could decide to rent or lease out the land during its six months of access.

Analysis

IE23 Each party now has an interest in the land and an interest in a joint venture. Although the land is legally owned by the company the terms of the joint arrangement give each of the parties rights of use of the land.

IE24 The parties recognise whatever rights of use they have under the agreement. They also recognise their interests in the company using the equity method. There should be no double counting of the land, because the operating agreement will have affected the value of the land held by the company.

Example 4 – Jointly held office building

IE25 Three companies (the venturers) set up a limited partnership to purchase a 15-floor office building. Financing for the acquisition of the building and working capital expenditure is arranged in the name of the partnership, secured on the value of the building.

IE26 Each venturer uses one of the floors for its own purpose. They each have a right to use that floor for their own purposes or, for example, to rent it independently to third parties. The venturers cannot sell their interest in that floor without selling their interest in the partnership.

IE27 The remaining 12 floors are rented to third parties. The partnership employs a management team to manage the business, including decision making on rental agreements entered into with third parties.

IE28 The partnership is controlled jointly by the venturers.

Analysis

IE29 The venturers each have a direct interest in one floor and an interest in the partnership.

IE30 The partnership is a joint venture. It controls assets, incurs liabilities and expenses, and earns income. The assets and liabilities would include the office building, any other assets such as furniture gathered by the partnership, and the borrowings incurred in financing the acquisition of the building and the operations of the partnership.

IE31 The partnership operates as a separate business with separate decision making in pursuit of common distinct objectives. The venturers have an interest in the profit generated by the operations of the partnership. They do not have a present obligation for the borrowings or other liabilities of the partnership, nor do they have rights to the individual assets of the venture.

IE32 The joint venture itself (the partnership) would recognise all of the remaining assets and liabilities of the joint arrangement, including the building, furniture, rent receivables, borrowings and operating liabilities. The building asset recognised by the joint venture would represent its rights to twelve floors of the building, including rights to any sale proceeds on disposal.

IE33 Each partner recognises its interest in the single floor. They also recognise their investment in the joint venture, using the equity method.

Variation – only one party has use of some floors

IE34 Suppose that rather than all three parties each having a right to use a floor only one of them, company B, has that right. Company B has use of three of the floors for its own purposes with the remaining 12 floors being rented to third parties.

Analysis

IE35 The change in the fact pattern does not change the nature of the joint arrangement, but obviously the interests of the individual parties are affected. In this case company B recognises as an asset its right to use three floors of the building. It also recognises its investment in the joint venture using the equity method.

IE36 The other two venturers recognise their interest in the partnership using the equity method.

Example 5 – Jointly owned shopping centre

IE37 Three real estate companies (the parties) purchase jointly a shopping centre. The parties have separately financed their share of the shopping centre acquisition.

IE38 They set up a partnership for the purpose of renting retail units to third parties, and transfer their ownership of the shopping centre to the partnership. The partnership employs a management team to manage the daily operations of the partnership but all strategic decisions (including decisions on tenants, rental prices and terms of the rental contracts) require the consent of all of the parties.

IE39 The terms of the partnership are such that the parties are jointly and severally liable for any liabilities of the partnership and there are pre-emptive rights arrangements if one party wishes to sell its interest.

IE40 Each party receives a share of the rental income from the property (net of any operating costs), on an ongoing basis.

Analysis

IE41 The partnership is a joint venture. The parties have given up their interest in the shopping centre and exchanged it for an interest in the partnership. The partnership operates as a separate business, generating revenue from the shopping centre. Although the parties are responsible for the liabilities of the partnership, this only results in a cash outflow if the partnership is unable to meet the obligations. The parties cannot sell, pledge or otherwise, access directly their share of the shopping centre. They do not have rights to the shopping centre, but have an interest in the partnership.

IE42 The parties recognise their borrowings, and a liability for any operating costs of the partnership that they are required to fund. The parties also recognise their interest in the partnership using the equity method.

Example 6 – Shopping centre with two owners

IE43 Two real estate companies (B and C) purchase jointly a shopping centre. They each finance their interest in the acquisition. The shopping centre has 30 retail units. B and C enter into an agreement whereby B receives rental income from the 10 largest retail units and C receives rental income from the remaining 20 retail units.

IE44 C is appointed as the manager of the shopping centre, responsible for the collection of rents and maintenance of the centre. C manages the centre according to the terms of the agreement, which is approved by B and C annually. C invoices B for its share of the operating expenditure.

IE45 The terms of the agreement are such that B and C can sell their interest in the retail units, or otherwise use any of the units for their own purposes, on approval by the other party.

Analysis

IE46 B has an interest in the 10 largest retail units whilst C has an interest in the 20 smaller retail units. B and C have direct access to the economic benefits generated from their respective interests in the shopping centre either by renting, selling or otherwise using the units. Each party has veto rights over the use of the other party's retail units. Whilst this would affect the value of the parties' interests in the shopping centre, it does not change the nature of those interests. The income received and expenses incurred by B relate to the 10 largest units. If one of those units is empty, B bears all of the costs associated with the unit; C's income is not affected if one of those largest units is empty.

IE47 The joint arrangement is not a separate business, carrying on activities in pursuit of objectives distinct from those of B and C. It is a means to share costs incurred in maintaining the shopping centre, and is an extension of each party's own operations.

IE48 B recognises its interest in the 10 largest retail units in the shopping centre, and recognises operating liabilities and costs relating to those units. B would also recognise payables to C for any operating costs incurred but not yet paid.

IE49 C recognises its interest in the 20 smaller retail units in the shopping centre, and the associated operating liabilities and costs. C would also recognise receivables from B for any operating costs incurred on B's retail units but not yet paid by B.

Example 7 – Joint oil and gas assets

IE50 Four entities (the parties) each have rights to extract minerals from adjacent areas. The entities have financed their respective acquisitions. The parties enter into a contract to explore, develop and extract minerals from the combined area (the field). Each entity retains its legal ownership of the extractive rights for its defined area.

IE51 The contract is for the economic extraction life of the defined area. Cancellation requires the consent of all of the parties. The contract gives the parties the pre-emptive right to acquire the interest of a party wishing to dispose of its interest in the arrangement.

IE52 The participation percentage of each party is based on their respective shares of the acreage held and contributed to the geologic area. The parties receive output from the joint arrangement in the form of oil that each can then hold, use or sell at their own discretion.

IE53 One party has been designated as the operator. The parties establish a 5-year strategic plan, which is updated annually on approval of all of the parties. The operator acquires equipment and allocates employees to the joint activities according to the strategic plan. The operator invoices the other parties for their share of expenses and capital expenditure based on their respective participations. Parties have joint and several liability for such obligations as decommissioning, environmental clean-up, etc.

Analysis

IE54 The joint arrangement is set up for the purposes of sharing costs and risks, not to carry on a separate economic activity. The arrangement does not pursue objectives, distinct from those of the parties. It is an extension of each party's operating activities to produce and sell oil.

IE55 The parties retain their right to the economic benefits generated from the mineral rights—the benefits (usually received in the form of oil) are directly related to the size of the mineral rights contributed to the arrangement. The parties have joint and several liability for obligations such as decommissioning, and also have obligations to reimburse their share of the costs incurred by the operator.

IE56 Each party controls its share of the joint productive equipment and other resources by directing the use of the equipment for the extraction of oil. That share of the equipment and resources is equivalent to the size of the party's mineral rights as a proportion of the total mineral rights of the field. Put another way, each party has rights of use of the productive equipment (to develop and extract the oil from its area) that are proportional to that party's mineral rights relative to the mineral rights of the combined field.

IE57 The parties recognise as assets and liabilities their respective interests in the mineral rights, productive equipment, oil produced, liabilities incurred, decommissioning liabilities and financing of the operations. The operator recognises receivables from the other parties (representing the other parties' share of expenses and capital expenditure borne by the operator). The non-operator parties recognise payables to the operator.

Example 8 – Mining joint venture

IE58 Four mining companies (the parties) each have rights to carry on exploration activities in adjacent areas. They set up a company to carry on the exploration activities jointly by pooling their resources. Each party exchanges its rights to explore for a share of the company. The company is financed by cash contributions from the parties. It purchases equipment, hires employees and appoints a management team to carry on the exploration operations. Each party has as seat on the board of the company and receives a share of any metal extracted by the company.

IE59 Strategic operating and financing decisions require the agreement of all shareholders.

Analysis

IE60 The company is a joint venture. It has been set up to carry on a separate economic activity exploring and extracting metal from the adjacent mining areas. The parties do not have individual rights to the assets or obligations for the liabilities. Each party has given up its right to explore in one area in return for a share of metal produced in the combined areas.

IE61 The parties recognise their interest in the company using the equity method.