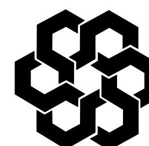

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International Accounting Standards Board

This document is provided as a convenience to observers at the Analyst Representative Group meeting, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the ARG meeting. Paragraph numbers correspond to paragraph numbers used in the ARG agenda paper.

INFORMATION FOR OBSERVERS

ARG Meeting: **November 2007, London**

Project: **ED9 *Joint Arrangements***

(Agenda Paper 6)

Introduction

1. The Board published ED 9 *Joint Arrangements* in September 2007. ED 9 proposes changes to accounting for interests in joint arrangements, and would replace IAS 31 *Interests in Joint Ventures*. It proposes the first major revision of accounting for joint arrangements since the publication of IAS 31 by the International Accounting Standards Committee in 1990.

2. A copy of ED9 is attached for your information. In addition, we have included a summary of the proposals and their effects in this paper.

Summary of the proposals in ED9 and reasons for those proposals

What was the purpose of a review of IAS 31?

3. The main aim of ED9 is to remedy two aspects of IAS 31 that the Board considers to be an impediment to high quality reporting.

a. The current accounting for joint arrangements follows the legal form in which activities take place. This does not always reflect the underlying rights and obligations agreed to by the parties. Shifting the focus to these rights and obligations will provide a more realistic reflection of a joint arrangement in the financial statements of the parties involved.

b. IAS 31 gives preparers a choice when accounting for interests in jointly controlled entities (accounted for using the equity method or proportionate consolidation), making it difficult to compare financial reporting.

The proposals in ED9

4. ED9 focuses on the contractual rights and obligations of the parties, rather than solely on the legal form of the arrangement. A party to a joint arrangement recognises the assets (and related revenue) to which it has rights and the liabilities (and related expenses) for which it is responsible, even if the joint arrangement operates in a separate legal entity. If a party only has rights to a share of the outcome of the activities, its net interest in the arrangement (described as an interest in a joint venture) is recognised using the equity method.

5. By changing the focus to contractual rights and obligations, ED9 removes the choice of accounting for a joint arrangement using proportionate consolidation.

6. ED9 also proposes additional disclosures:

    a. A description of the nature and extent of an entity's operations conducted through joint arrangements.

    b. Summarised financial information for each individually material joint venture, and in total for all other joint ventures.

Basic examples

7. ED9 identifies three types of joint arrangement—joint operation, joint asset and joint venture. One joint arrangement could be a combination of any two or more of these. The illustrative examples to ED9 provide more comprehensive examples of each of the three types of joint arrangement.

Joint operation

Two parties set up a joint arrangement for the sale and distribution of a drug. One party develops the drug and retains the rights to the patent for that drug. The other party carries out the sales effort and distributes the drug worldwide.

Each party retains rights to its own assets, and responsibility for its own liabilities and expenses. The joint arrangement would detail how revenue from the sale of the drug would be split between the parties.

Joint asset

Two parties purchase jointly a cable network. Each has exclusive rights to use 50% of the capacity of the network (to use for its own purposes or to sell any unused capacity to other third parties). Each party would recognise as an asset its 50% share of the cable network, its share of any costs incurred in maintaining the network and revenue from the sale of any of its capacity.

Joint venture

Two parties set up a company and transfer their joint ownership of an office building to the company. The company employs a management team and rents the offices to third parties. The parties jointly control the company and are entitled to a share of the profit or loss generated from the rental business (the parties are not individually responsible for any costs of the company).

Each party would recognise its net interest in the company using the equity method.

Joint asset and joint venture

Two parties set up a company that they jointly control. The company purchases a cable network. The parties each enter into an agreement with the company for use of 20% of the capacity of the cable network. The remaining 60% capacity is leased to third parties by the company. The parties are entitled to a share of the profit generated by the company.

Each party would recognise its right to use the cable network (interest in a joint asset), and its net interest in the company (joint venture) using the equity method.

Financial reporting effect

8. The initial reaction of some [constituents] is that removing the ability to use proportionate consolidation will lead to some entities presenting fewer assets and liabilities in their statements of financial position, and lower revenues and expenses in their statements of comprehensive income. This is portrayed as a negative effect.

9. We are not of this view. Firstly, the new standard is unlikely to change the financial reporting of many entities significantly. Secondly, for those whose financial reporting will be changed, we believe that the financial reporting that results will be a more faithful representation of those entities' financial positions and performance.

10. In many circumstances, accounting for contractual rights and obligations gives the same outcome as proportionate consolidation. ED9 will have little effect on the financial statements of an entity:

    a. if it has rights to individual assets (and related revenue) and responsibility for liabilities (and related expenses) of a joint arrangement, and that joint arrangement is not a legal entity or it is a legal entity that was accounted for previously using proportionate consolidation.

    b. if it has rights only to a share of the outcome of the activities of a joint arrangement, and that joint arrangement is a legal entity that was accounted for previously using the equity method.

11. There are two types of entity for which the changes could be significant. The first is those entities that have been using proportionate consolidation and are recognising assets and liabilities in their financial statements even though they have no rights to the assets or responsibility for the liabilities. If the joint arrangement does not give the entity rights to individual assets, the entity should not report them in its statement of financial position. Instead, those entities will now recognise their interest in the joint arrangement as one-line in the statement of financial position and statement of comprehensive income (using the equity method).

12. The second is those entities that have rights to assets and responsibility for liabilities, but do not recognise those rights and responsibilities, because they are using the equity method of accounting. ED9 would require that they recognise those assets and liabilities (and related revenue and expenses) in their financial statements.

13. ED9 also asks entities to apply more rigour when assessing what interests they have in joint arrangements. A party could have both contractual rights to assets and responsibility for liabilities, and also have a net interest in the remaining assets and liabilities of one joint arrangement (for example, basic example: joint asset and joint venture in paragraph 7 of this paper, or example 3 of the illustrative examples to ED9).

Why the new proposals are an improvement

14. We are of the view that the proposals result in the right accounting in terms of recognition of assets, liabilities, revenue and expenses. Entities would recognise assets to which they have rights, and liabilities for which they are responsible.

The proposals in ED9 also improve financial information disclosures for interests in joint ventures.

Reactions so far

Removal of proportionate consolidation

15. As mentioned previously, the first reaction of many is that removing proportionate consolidation will result in the loss of valuable information.

16. Our view is that the proposals will only result in assets and liabilities being removed from the statement of financial position if those items are not actually assets and liabilities of the reporting entity.

17. Proportionate consolidation can lead to an entity reporting as its own assets and liabilities items that do not meet the definition of assets and liabilities in the IASB's *Framework*, ie items that the entity does not control and for which it does not have an obligation. For example, an entity might report cash that it cannot use, gain access to or benefit from without the consent of others, as if it were its own.

18. We hope that the proposed disclosure requirements would replace any potential loss of information from the primary financial statements (refer to paragraph 24 of this paper for details of the disclosure requirements). When an entity has a joint venture and uses the equity method, the disclosures proposed are enhanced to require summarised financial information (current and non-current assets and liabilities, revenue and profit or loss) for each individually material joint venture, as well as in total for all others.

19. We are also aware that some believe that removing proportionate consolidation will not allow an entity to recognise individual assets, liabilities, revenue and expenses relating to interests in joint arrangements.

20. This belief is untrue. ED9 proposes to remove proportionate consolidation as it is defined in IFRS literature. It does not prevent the recognition of individual assets and liabilities, or a share of them, and the related revenue and expenses. In fact, it requires their recognition when an entity has rights and responsibility for those items.

Use of the equity method

21. Some have indicated that, although they agree with the general approach that the Board is taking, they do not think that the equity method is an appropriate means of measuring an investment in an entity or venture.

22. ED9 is the result of the Board's short-term project addressing joint arrangements. Therefore the Board's intention was never to review all aspects of IAS 31. The equity method has been used to account for investments in associates and joint ventures for many years in jurisdictions around the world. The Board therefore did not deem it feasible or appropriate to reconsider the equity method as part of a short-term project.

23. [This paragraph has not been reproduced in observer notes].

Questions for discussion

24. The exposure draft includes six questions of interest to the Board. For the purposes of this discussion, we are particularly interested in your comments on the disclosure requirements proposed in ED9:

Extract from ED9—proposed disclosure requirements

36 An entity shall provide a description of the nature and extent of its operations conducted through each of the three types of joint arrangement—joint operations, joint assets and joint ventures.
[new requirement]

37 An entity shall disclose the aggregate amount of the following commitments separately from other commitments:

(a) any capital commitments it has relating to its interests in joint arrangements; and

(b) its share of capital commitments incurred jointly with other parties. *[carried forward from IAS 31]*

38 In accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, an entity shall disclose:

(a) any contingent liabilities incurred relating to its interests in joint arrangements; and

(b) its share of contingent liabilities incurred jointly with other parties. *[carried forward from IAS 31]*

39 A venturer shall disclose information that enables users of its financial statements to evaluate its activities conducted through joint ventures. To meet this objective, a venturer shall disclose the following information:

(a) a list and description of interests in significant joint ventures and the proportion of ownership interest held.
[carried forward from IAS 31]

(b) for each individually material joint venture, and in total for all other joint ventures, summarised financial information, including, but not necessarily limited to, the venturer's interest in the amount of each of:

(i) current assets,

(ii) non-current assets,

(iii) **current liabilities,**

(iv) **non-current liabilities,**

(v) **revenues, and**

(vi) **profit or loss.**

[expanded disclosures required—IAS 31 requires summarised financial information in total for all jointly controlled entities; not for each individually material jointly controlled entity]

(c) **the end of the reporting period of the financial statements of a joint venture, when such financial statements are used in applying the equity method and are as of a date or for a period that is different from that of the venturer, and the reason for using a different date or different period.**
[new requirement; consistent with IAS 28 Investment in Associates*]*

(d) **the nature and extent of any significant restrictions (eg resulting from borrowing arrangements or regulatory requirements) on the ability of joint ventures to transfer funds to the venturer in the form of cash dividends, or repayment of loans or advances.**
[new requirement; consistent with IAS 28]

(e) **the unrecognised share of losses of a joint venture, both for the period and cumulatively, if a venturer has discontinued recognition of its share of losses of a joint venture.**
[new requirement; consistent with IAS 28]

40 **A venturer shall disclose separately its share of the profit or loss of joint ventures accounted for using the equity method, and the carrying amount of those interests. The venturer shall also disclose separately its share of any discontinued operations of such joint ventures. The disclosures are presented in total for all joint ventures.**
[new requirement; consistent with IAS 28]

41 **A venturer shall recognise in other comprehensive income its share of changes recognised in other comprehensive income by joint ventures.**
[new requirement; consistent with IAS 28]

Question 1: Do you think that the disclosure requirements proposed will provide information useful for decision-making? If not, what disclosure requirements would you suggest?

25. We would also welcome comments on any other aspect of ED9, including removal of proportionate consolidation and the use of the equity method. Paragraphs 15 to 23 of this paper include initial reactions to ED9 from some constituents, as well as our view of the effects of those proposals.

Question 2: What are your views on the removal of proportionate consolidation and the use of the equity method?