Project **Joint Ventures**

Topic **Transactions between a party and a joint arrangement: inconsistency between IAS 27 and SIC-13**

1. **This paper discusses the accounting for transactions (ie sales, purchases or contributions of non-monetary assets) between a reporting entity and a joint arrangement, in which it is an operator or venturer. There is an inconsistency within IFRS. The aim of this paper is to provide information that will enable the Board to make a decision on how and when to tackle this inconsistency.**

2. There is an inconsistency between the requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* that was not addressed by ED 9 *Joint Arrangements.*[1] The inconsistency relates to the accounting for gains and losses resulting from contributions of non-monetary assets to joint arrangements.

3. Although we think that the Board should address this inconsistency, we think that we can complete the Joint Arrangements Standard and address this inconsistency separately.

4. The paper has three sections:

   (a) The current accounting requirements and the inconsistency observed [paragraphs 5-16 of this Agenda Paper];

   (b) The equivalent accounting requirements proposed by ED 9 [paragraphs 17-19]; and

[1] Please note that ED 9 *Joint Arrangements* replaces IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers.*

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

(c) Our analysis and recommendations [paragraphs 20-27].

Current requirements

5. The accounting for transactions between a venturer and a joint venture is currently set out in IAS 31 and SIC-13. IAS 31 has the following requirements for transactions between a venturer and a joint venture:

> 48. When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction shall reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer shall recognise only that portion of the gain or loss that is attributable to the interests of the other venturers. The venturer shall recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.
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> 49. When a venturer purchases assets from a joint venture, the venturer shall not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer shall recognise its share of the losses resulting from these transactions in the same way as profits except that losses shall be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.
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> 50. To assess whether a transaction between a venturer and a joint venture provides evidence of impairment of an asset, the venturer determines the recoverable amount of the asset in accordance with IAS 36 Impairment of Assets. In determining value in use, the venturer estimates future cash flows from the asset on the basis of continuing use of the asset and its ultimate disposal by the joint venture.

6. SIC-13 addresses non-monetary contributions to a jointly controlled entity (JCE) in exchange for an equity interest in the JCE that is accounted for using either the equity method or proportionate consolidation. The Interpretation states:

> 5. In applying IAS 31.48 to non-monetary contributions to a JCE in exchange for an equity interest in the JCE, a venturer shall recognise in profit or loss for the period the portion of a gain or loss attributable to the equity interests of the other venturers except when:
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> (a) the significant risks and rewards of ownership of the contributed non-monetary asset(s) have not been transferred to the JCE; or
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> (b) the gain or loss on the non-monetary contribution cannot be measured reliably; or

> (c) the contribution transaction lacks commercial substance, as that term is described in IAS 16.[2]
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> If exception (a), (b) or (c) applies, the gain or loss is regarded as unrealised and therefore is not recognised in profit or loss unless paragraph 6 also applies.
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> 6. If, in addition to receiving an equity interest in the JCE, a venturer receives monetary or non-monetary assets, an appropriate portion of gain or loss on the transaction shall be recognised by the venturer in profit or loss.
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> 7. Unrealised gains or losses on non-monetary assets contributed to JCEs shall be eliminated against the underlying assets under the proportionate consolidation method or against the investment under the equity method. Such unrealised gains or losses shall not be presented as deferred gains or losses in the venturer's consolidated statement of financial position.

7. Therefore both IAS 31 and SIC-13 require that gains and losses resulting from transactions between a reporting entity and its JCE be recognised only to the extent of the interests of the other equity holders. SIC-13 also specifies some factors to consider before the gains and losses are considered to be 'realised' (SIC-13.5 (a)-(c)). These specific factors are not included in IAS 31.

Inconsistency between SIC-13 and IAS 27

8. There is an inconsistency between SIC-13 and IAS 27 when a subsidiary is contributed to a JCE. As mentioned above, SIC-13 requires gains or losses arising from contributions of non-monetary assets to a JCE to be recognised only to the extent of the interests attributable to the other equity holders in the JCE, if the gain or loss is regarded as 'realised'. Contributions are described in SIC-13 as follows:

> SIC-13.2 Contributions to a JCE are transfers of assets by venturers in exchange for an equity interest in the JCE. Such contributions may take various forms.

9. A non-monetary contribution could include a subsidiary that is contributed to a JCE in exchange for an equity interest in the JCE.

10. The application of paragraph 34 of IAS 27 to the contribution of non-monetary assets housed in a subsidiary would result in the contributing party:

[2] IAS 16.25: 'An entity determines whether an exchange transaction has *commercial substance* by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if: (a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or (b) the entity-specific value of the portion of the entity's operations affected by the transaction changes as a result of the exchange; and (c) the difference in (a) or (b) is significant relative to the fair value of the assets exchanged.'

(a) derecognising the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

(b) derecognising the carrying amount of any non-controlling interests in the former subsidiary at the date when control is lost (including any components of other comprehensive income attributable to them);

(c) recognising:

(i) the fair value of the consideration received, if any, from the transaction, event or circumstances that resulted in the loss of control; and

(ii) if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;

(d) recognises any investment retained in the former subsidiary at its fair value at the date when control is lost […].

11. This accounting requirement is supported by the following explanation in paragraph 55 of the Basis of Conclusions of IAS 27:

> 'any investment the parent has in the former subsidiary after control is lost should be measured at fair value at the date that control is lost and […] **any resulting gain or loss should be recognised in profit or loss.** […] Measuring the investment at fair value reflects the Board's view that the loss of control of a subsidiary is a **significant economic event**. The parent-subsidiary relationship ceases to exist and an investor-investee relationship begins that differs significantly from the former parent-subsidiary relationship. Therefore, the new investor-investee relationship is recognised and measured initially at the date when control is lost.'

12. The following example illustrates this inconsistency.

13. An entity holds a 100 per cent interest in a subsidiary that has net assets with a carrying amount of CU4,000. The entity contributes its interest in the subsidiary in exchange for a 50 per cent interest in a new joint arrangement. The parties agree that the total value of the new joint arrangement is CU10,000.

(a) Applying SIC-13 to the transaction above:

	Dr	(Cr)
Investment in joint arrangement	4,500	
Net assets of subsidiary contributed		4,000
Gain on disposal		500

(b) Applying IAS 27 to the transaction above:

	Dr	(Cr)

	Dr	(Cr)
Investment in joint arrangement	5,000	
Net assets of subsidiary contributed		4,000
Gain on disposal		1,000

14. A similar inconsistency would arise if a party contributed an interest in a subsidiary to a joint arrangement and this contribution did not result in the loss of control of the subsidiary. In this case an entity using IAS 27 would account for any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration received directly in equity.

15. The following example illustrates this inconsistency.

16. An entity holds a 100 per cent interest in a subsidiary that has net assets of CU4,000. The entity contributes a 10 per cent interest in the subsidiary in exchange for a 50 per cent interest in a new joint arrangement. The parties agree that the total value of the new joint arrangement is CU1,000.

(a) Applying SIC-13 to the transaction above:

	Dr	(Cr)
Investment in joint arrangement	450	
Non-controlling interest (CU 4,000 X 10%)		400
Gain on disposal		50

(b) Applying IAS 27 to the transaction above:

	Dr	(Cr)
Investment in joint arrangement	500	
Non-controlling interest (CU 4,000 X 10%)		400
Entity's other reserves		100

Accounting requirements proposed by ED 9

17. ED 9 includes the following accounting requirements for transactions between the parties and the joint arrangement:

> 27. When a venturer enters into a transaction with a joint venture, it recognises gains or losses resulting from the transaction in accordance with paragraph 22 of IAS 28. Those transactions would include, for example, the sale, purchase or

contribution of assets, including the contribution of a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture.

18. IAS 28.22 states:

> 22. Profits and losses resulting from 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and an associate are recognised in the investor's financial statements only to the extent of unrelated investors' interests in the associate. […].'

19. ED 9 would not resolve the inconsistency between IAS 27 and SIC-13 when accounting for contributions of non-monetary assets described in paragraphs 8-16 above.

Staff analysis

Some background information

20. Some of the big audit firms have also observed the tension between SIC-13 and IAS 27 and have told us that this will become a problem in practice (please note that the accounting requirements in IAS 27 relating to the 'loss of control' only came into effect for annual periods beginning on or after 1 July 2009).

21. There are currently different interpretations relating to the application of the standards for those cases when a party contributes an interest in a subsidiary to a JCE resulting in the loss of control of the subsidiary:

    (a) Some interpret that the requirements of IAS 27 should be applied first (ie full recognition of gains and losses) and then SIC-13 should be applied (ie elimination of gain and losses relating to the party's interest).

    (b) Some interpret that the final accounting is a company's accounting policy matter (ie using IAS 27 or SIC-13 depends on the accounting policies of the entity).

    (c) A third interpretation is that if the non-monetary assets contributed are in a subsidiary then IAS 27 shall be applied, whereas if the non-monetary assets are not placed within a subsidiary the requirements of SIC-13 are the ones that shall be applied.

22. Before analysing the different options available to us, we note that the following discussions have already been held with the Board:

    (a) In May 2009 the staff pointed out the different requirements in IAS 27 and IAS 31/SIC-13 to account for the contribution of a subsidiary to a JCE (see Agenda Paper 13K *Amendments to IFRS 3 and IAS 27 – Other Issues*). The staff recommended that this issue be addressed in a revision of Equity Accounting or as part of other current projects such as Joint Ventures and Consolidation. At the Board meeting in May 2009 the Board agreed to the staff recommendation.

    (b) Also in May 2009, the staff informed the Board about the FASB deliberations relating to the amendment of the scope of SFAS 160 *Noncontrolling Interests in Consolidated Financial Statements* (see Agenda Paper 13J *Information on EITF 08-10 and FASB Proposal on Scope of SFAS 160*). In a meeting in April 2009 the FASB addressed the matters raised in EITF 08-10 *Selected Statement 160 Implementation Questions*. One of those matters was 'how an entity should account for the transfer of an interest in a subsidiary in exchange for a joint venture interest that results in deconsolidation of the subsidiary'.[3] The FASB decided that Statement 160 should apply when a subsidiary that is a business or non-profit activity is transferred to an equity method investee or joint venture (ie an entity deconsolidates a subsidiary when it ceases to control that subsidiary; upon deconsolidation, the entity recognises a gain or loss in profit or loss attributable to the parent and measures any retained interest in the subsidiary at fair value). The requirements proposed in the Exposure Draft *Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope clarification* issued in August 2009 by the FASB are aligned with the FASB's decision described above.

Analysis

[3] Issue 3 of EITF 08-10 *Selected Statement 160 Implementation Questions*.

23. The inconsistency between SIC-13 and IAS 27 is closely related to the following topics:

    (a) the definition of 'group' and its implications in the measurement requirements of investments outside the group boundaries such as joint arrangements and associates; [4]

    (b) the current equity method itself, which requires recognition of gains and losses resulting from 'upstream' and 'downstream' transactions between an investor and an associate only to the extent of unrelated investors' interests in the associate; and

    (c) the initial inconsistency between the principle that loss of control is a 'significant economic event' that triggers *full* recognition of gains and losses, while SIC-13 requires only *partial* recognition of gains and losses;

24. Dealing with these topics would require, among other things:

    (a) A review of the measurement requirements for interests held in joint ventures and associates and their consistency with the Group definition, which would imply a thorough review of the 'equity method';

    (b) A thorough review not only of the accounting for contributions of non-monetary assets to joint arrangements but also a review of the accounting for upstream and downstream transactions to joint arrangements and associates, taking into consideration the accounting treatment of unrealised gains and losses resulting from these transactions;

    (c) Clarification of the scope and interaction between IFRS 3 *Business Combinations*, IAS 27, IAS 31, SIC-13 and IAS 28 - The review of the accounting for transactions between the parties and the joint arrangements or investors and associates should provide consistent guidance in the following different situations:

[4] According to IAS 27, 'a *group* is a parent and all its subsidiaries'.

(i) Sale/contribution of subsidiaries (subsidiaries might house a business or assets that do not qualify as a business);

(ii) Sale/contribution of businesses (not housed within a subsidiary);

(iii) Sale/contribution of assets (not housed within a subsidiary).

(d) Clarification of the interaction between IFRS 3 *Business Combinations*, IAS 27, IAS 31, SIC-13 and IAS 28 – The accounting for acquisitions and for step-acquisitions of equity accounted investments poses the following challenges:

(i) IAS 28.11 requires that 'the investment in an associate is initially recognised at cost […]'and IAS 28.20 states '[…] the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for an investment in an associate'. The question is whether entities should analogise fully to IFRS 3 (ie expense transaction cost, include contingent consideration based on its fair value with subsequent changes in profit and loss), or should entities instead retain a cost approach (ie analogising to other standards, transaction and directly attributable costs are included in the initial measurement of cost)?

(ii) Is gaining 'significant influence' or 'joint control' a significant event in the same way that gaining 'control' is a significant event?[5] Should those step-acquisitions in

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[5] Please note that the loss of 'control', 'joint control' and 'significant influence' are considered to be economically similar events that change the nature of the investment. Consequently the accounting guidance on the loss of control, joint control or significant influence in IAS 27, IAS 31 and IAS 28 is consistent (ie the investor measures any retained interest at fair value and any difference between the carrying amount of the investment when control, joint control or significant influence is lost, the disposal proceeds (if any) and the fair value of any retained interest is recognised in profit or loss).

joint ventures and associates fully analogise with IFRS 3?[6] How should gains and losses be measured and recognised?

(e) Clarification of the accounting for changes in ownership interests in joint arrangements and in associates: how should changes in ownership interests in joint arrangements and associates be accounted for? Should the accounting for decreases in ownership interest fully analogise with the accounting proposed in IAS 27.30 for changes in a parent's ownership interest in a subsidiary that do not result in a loss of control (ie equity transactions)? Should the accounting for increases in ownership interest fully analogise with the step acquisition in IFRS 3 (ie subsequent increases in the investment trigger remeasurement of the underlying assets and liabilities of the joint arrangement or the associate) or should measurement distinguish between the new interest based on the new cost and the old interest at the original cost?

(f) Consideration of the requirements under US GAAP in order to assess how convergent would the new IFRS requirements be compared to the US GAAP ones. Please note that a similar inconsistency to the one discussed in this paper currently exists under US GAAP as addressed by paragraph 13 of the Basis for Conclusions of the Exposure Draft *Accounting and Reporting for Decreases in Ownership of a Subsidiary —a Scope Clarification:*

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[6] IAS 28.11 states that 'the investment in an associate is initially recognised at cost', however, when accounting for acquisition of an investment in an associate, IAS 28.20 states '[…] the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate'. Should step acquisitions of equity-accounted investments fully analogise to IFRS 3 or should they be accounted for by using a cost accumulation approach (ie cost of an associate achieved in stages would include the consideration paid for each purchase)?

> BC13. The Board also clarified that Subtopic 810-10[7] applies if an entity transfers a subsidiary or group of assets that is a business or nonprofit activity to an equity method investee or joint venture. Constituents questioned whether Subtopic 810-10 should apply to these situations because Topic 323[8] provides guidance on accounting for transactions with an equity method investee including joint ventures. That Topic prohibits recognition of gain or loss on transactions with an equity method investee until the gain or loss has been realized through transactions outside of the group. That guidance conflicts with the accounting required by Subtopic 810-10. The Board noted that Subtopic 810-10 explicitly requires that a subsidiary be deconsolidated and that a gain or loss be recognized in earnings if the entity loses control of the subsidiary, including any gain or loss associated with a retained investment. The Board believes that inherent in that conclusion is that a retained investment could subsequently be accounted for as an equity method investment. Accordingly, the Board does not believe that the accounting treatment should differ on the basis of whether the transaction was with a new or existing equity method investee or joint venture.

Recommendation

25. We think that the most significant improvements to the accounting for joint arrangements relate to the definition and classification of the arrangements between joint operations and joint ventures. Publication of this important improvement could be delayed if the inconsistency between SIC-13 and IAS 27 is dealt within the Joint Ventures project, because it is likely that some aspects of the solutions would need to be exposed first.

26. We think that the areas that will need to be addressed to resolve the inconsistency do warrant additional work. But that work should not delay the publication of the new Joint Arrangements Standard. We intend incorporating

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[7] Subtopic 810-10-40.4 and 40.5 state: 40.4 A parent shall deconsolidate a subsidiary as of the date the parent ceases to have a controlling financial interest in the subsidiary. 40.5 If a parent deconsolidates a subsidiary through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in Subtopic 845-10, applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:
a. The aggregate of all of the following: 1. The fair value of any consideration received 2. The fair value of any retained noncontrolling investment in the former subsidiary at the date the subsidiary is deconsolidated 3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.
b. The carrying amount of the former subsidiary's assets and liabilities.

[8] Topic 323 deals with *Investments – Equity Method and Joint Ventures*.

the sections on the application of the equity method to joint ventures as consequential amendments to IAS 28. By doing so we will not need to amend the Joint Arrangements Standard again if we address the inconsistencies created by the equity method.

27. Agenda Paper 11-C discusses the modifications that we recommend to be incorporated into the consequential amendments to IAS 28, assuming the Board agrees with our recommendation.

Question 1
Does the Board agree that the current requirements of SIC-13 should be incorporated in the consequential amendments to IAS 28 and that the inconsistency with IAS 27 should be resolved separately?