Project **Joint Venture**

Topic **Clarification of the accounting requirements for 'joint operations'**

Clarification of the accounting requirements for 'joint operations': unit of account and nature of the assets and liabilities to be recognised

1. The topic of this Agenda Paper was introduced in item *(f) Clarification of the accounting requirements for 'joint operations/assets'* of Agenda Paper 8A presented to the Board at its May 2009 meeting. This item was not discussed at that meeting.

2. This Agenda Paper details the main areas where clarification in the final standard is needed relating to the accounting for a party of its interests in a 'joint operation' and the corresponding recommendations provided by the staff.

Areas that need clarification in the accounting of 'joint operations'

3. As discussed in the comment letter analysis in April 2008, many respondents raised concerns relating the accounting for a party of its interest in a 'joint operation'. The concerns were mainly the following:

   (a) the determination of the 'unit of account';

   (b) the nature of the assets and liabilities to be recognised; and

   (c) the difference between an entity recognising its share of assets, liabilities, revenues and expenses and proportionate consolidation.

4. We think that the concerns above have arisen as a result of the elimination of proportionate consolidation as a method to account for interests in jointly controlled entities (JCEs) and as a result of a perceived lack of clarity in the

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articulation of the requirements for the accounting of interests held by parties in 'joint operations' provided in the exposure draft.

5. We note, however, that the same issues stated above in paragraph 3 (a) and (b), could potentially be current matters of concerns when considering the existing accounting requirements for arrangements classified as 'jointly controlled operations' or 'jointly controlled assets' in accordance to IAS 31 *Interests in Joint Ventures*. Therefore we think that the concerns raised by ED 9 *Joint Arrangements* are in many instances more related to the interpretation of the potential changes perceived to be introduced by the proposals than to the real changes that were initially conceived to be introduced by ED 9.

Unit of account

6. Respondents to the comment letters highlighted two main points in relation to the 'unit of account':

   (a) Some respondents stated that the predominant reason for the IASB's rejection of proportionate consolidation is that it is inconsistent with the Framework and presents assets that the entity does not control on the balance sheet of the entity. These respondents believe that the same criticism could be levied at the inclusion of a proportionate share or component of an asset on the balance sheet of an entity as the asset as a whole is not under the control of the entity.

   (b) On what basis the unit of account can be delineated, ie which factors should be considered in the determination of a part of an asset as the 'unit of account'?

7. Like many of the respondents to the Invitation to Comment to ED 9, we think that some of the issues relate to the definitions of an asset and a liability, which are part of ongoing work in the Conceptual Framework project. While willing to clarify the accounting requirements to account for the interests of a party in a 'joint operation', we think that we should also be careful not to go far beyond the scope of the new standard on Joint arrangements by introducing

requirements that could be perceived to pre-judge the conclusions to be reached on issues that are currently being debated in other projects.

Accounting for shares of assets might be also inconsistent with the Framework

8. Some constituents have challenged the recognition of shares of assets by stating that this might be as inconsistent with the Framework as proportionate consolidation method. For example, BC 18 and BC 9 of ED 9 state:

> BC18. '[...] If an entity shares an asset, it recognises only those rights to the asset that it controls. Similarly, if an entity shares an obligation, it recognises only that portion of the obligation that it currently has'.
>
> BC9. 'The Board concluded that proportionate consolidation is not an appropriate method of accounting for jointly controlled entities. Recognising a proportionate share of each asset and liability of an entity is not consistent with the *Framework*, which defines assets in terms of exclusive control and liabilities in terms of present obligations. It leads to the recognition of amounts that do not represent faithfully an entity's assets and liabilities'.

9. Some respondents see these as being contradictory statements. We think that the final standard should give more emphasis to arguments explaining 'when' it is appropriate that an entity accounts for its share of assets and liabilities arising from an arrangement (detailing as well 'when' and 'how' accounting for assets and liabilities based on the terms of the agreement is expected to result in a different outcome than proportionate consolidation) and 'when' is it appropriate that an entity, instead, accounts for an investment in an arrangement, rather than focusing the arguments in the elimination of an option based on conceptually challengeable basis.

10. The argument to shift the focus towards determining 'when' arrangements entitle entities to the recognition of assets and liabilities and 'when' they entitle entities to the recognition of an investment instead of focusing the arguments on the elimination of a particular option gain particular relevance when we acknowledge that in many instances the accounting outcome obtained from the accounting of a party' share of assets and liabilities will be the same or very similar than the outcome obtained from applying proportionate consolidation.

11. Paragraphs BC 8 and BC 10 of the Basis of Conclusions of ED 9 emphasise the main objective of the proposals:

> BC8. The accounting requirements of IAS 31 can lead to the recognition of assets that are not controlled and liabilities that are not obligations. [...] It does not, however, control each asset nor does it have a present obligation for each liability to the jointly controlled entity. Rather, each party has control over its investment in the entity. **If the party uses proportionate consolidation to account for its interest in a jointly controlled entity, it recognises as assets and liabilities a proportion of items that it does not control or for which it has no obligation.**
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> BC10. In addition, IAS 31 can lead to an entity not recognising its assets and liabilities. When a jointly controlled entity is similar in substance to jointly controlled operations or jointly controlled assets, a party controls assets and has obligations relating to the activities of the joint arrangement. These assets and liabilities should be recognised in the party's financial statements. However, **if the party accounts for such jointly controlled entities using the equity method** (because IAS 31 emphasises the form of the arrangement), **the party does not recognise the assets it controls and its liabilities.**

Basis to determine the 'unit of account'

12. The current requirements in IAS 31.21 state the following:

> 'In respect of its interest in jointly controlled assets, a venturer shall recognise in its financial statements:
>
> (a) its share of the jointly controlled assets, classified according to the nature of the assets; [...]
>
> (c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture; [...].'

13. Similar concerns to those raised in connection to ED 9 relating which factors should be considered to determine the 'unit of account' could also arise considering the accounting requirements of IAS 31 above. We think that generally the agreements between the parties delineate the 'share' or 'part' of the asset/liability in which the different parties to a 'joint operation' have an interest.

14. The accounting requirements of ED 9 are not intended to represent a change in this respect to IAS 31, whereby the 'share' is determined based on the contractual arrangement:

> 14. [...] Each venturer bear its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined **in accordance with the contractual arrangement.**
>
> 23. [...] Separate accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers **according to their agreed shares.**

15. We acknowledge that the guidance provided in IAS 31 does not explicitly deal with how the 'share of the assets/liabilities' to be accounted for is determined. However, IAS 31 does provide enough guidance to conclude that the share of the revenue, for example, is 'agreed' and is generated from 'the share' that each venturer has on the joint asset, which is, as we have observed, also generally agreed by the parties to a 'joint operation'. As such IAS 31.19 states, '[…]. Each venturer has control over its share of future economic benefits through its share of the jointly controlled asset.'

16. In that respect, ED 9 did not intend to represent a change from IAS 31. We propose to explain in the Basis for Conclusions that the primary source of guidance to determine the 'unit of account' of the assets and liabilities to be recognised by the parties to 'joint operations' will be the agreements themselves.

Question 1
Does the Board agree with the proposal to: (a) shift the focus in the Basis to address when it is appropriate for an entity to account for its share of assets / liabilities and when to account for an investment instead of focusing on the elimination of an accounting option? (b) state in the Basis of Conclusions that it is not the intention of ED 9 to change current guidance in IAS 31 in relation to the 'unit of account' to be considered when accounting for an asset / liability?, and (c) explain that the determination of the 'unit of account' generally is provided by the terms agreed by the parties to the arrangement?

Nature of the assets and liabilities to be recognised

17. One of the points raised by many respondents is whether a party to a joint asset[1] should recognise its 'rights to use' or 'rights of use' (as referred in the Illustrative Examples) or its 'right to a share' (ED 9.12) or whether it should

[1] Please note that the Board decided at its May 2009 meeting that this type of joint arrangement will be called 'joint operation' in the final standard.

directly recognise 'its share of the joint asset, classified according to the nature of the asset' (ED 9.22).

18. The concern raised by this uncertainty is the different accounting implications of these two possible interpretations of the accounting requirements in the draft standard—ie rights or shares of assets. Additionally, the requirement to account for 'rights to use in accordance with applicable IFRSs' has led many respondents to enquire which would be the applicable standard in the case 'rights to/of use' should be the final accounting requirement.

19. In this respect, one respondent stated that 'many IFRSs do not explicitly consider the recognition and measurement of a part of an asset or a shared obligation. Accordingly, the reader is left to determine how items should be treated. For instance, should an undivided interest in a tangible asset be considered a tangible asset in its own right, a right of access/use, a leased asset, some form of intangible asset or something else?'

20. In drafting ED 9 we used the term 'right of use' to illustrate that an entity could report individual assets even if the assets were hosted in an incorporated entity. We borrowed the words 'right of use' from the *Framework*, because the *Framework* acknowledges that the right of ownership is not essential for an entity to recognise an asset.[2] However, this has caused confusions as to which is the nature of the assets and liabilities to be recognised by parties in 'joint operations'.

21. We believe that the recognition and measurement of 'rights of use' is an issue that goes far beyond the new standard on Joint arrangements, that is already dealt with IAS 17 *Leases* and IFRIC 4 *Determining whether an arrangement contains a lease*, and that is currently being discussed in the Leases project. Additionally, since the different references to 'rights of use' in the draft standard and examples intended only to illustrate when an asset needed to be recognised in the financial statements of an entity, we do not believe the final standard on Joint arrangements should conclude that the interests of the parties to the assets

[2] Framework paragraph 57.

used in a 'joint operation' represent 'rights of use' and that the latter is 'the nature' of the assets that a party to a 'joint operation' should account for.

22. Similarly, the Basis of Conclusions of ED 9 refers to the accounting for assets and liabilities as a result of parties having contractual rights and obligations arising from the arrangement without stating that the nature of such assets are 'rights of use' (eg, ED 9. BC11 states '[...] the Board also concluded that recognising a net interest in a joint arrangement (for example, when using the equity method) is not appropriate when the parties have contractual rights and obligations relating to individual assets and liabilities of the joint arrangement'). In fact there is no mention to 'rights of use' as the nature of the assets to be recognised in 'joint operations' in the entire Basis of Conclusions of ED 9. This reinforces that accounting for 'rights' was not the intention behind the requirements of ED 9.

23. However, requiring a party to recognise 'its share of the joint asset, classified according to the nature of the asset', as required by ED 9.22, is pre-empting that the recognition and measurement of the share of the asset should follow the standard in which this share has been classified. This alternative, even though consistent with the current requirements in IAS 31.22(a)[3], could, however, also be considered to be a requirement that goes beyond the scope of the new standard. The main objective is to identify when the accounting for assets and liabilities in some arrangements is appropriate - ie per ED9.BC10, 'when a jointly controlled entity is similar in substance to jointly controlled operations or jointly controlled assets, a party control assets and has obligations relating to the activities of the joint arrangement. These assets and liabilities should be recognised in the party's financial statements. However, if the party accounts for such jointly controlled entities using the equity method [...], the party does not recognise the assets it controls and its liabilities'.

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[3] IAS 31.22 states: 'In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognises in its financial statements: (a) its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment. For example, a share of a jointly controlled oil pipeline is classified as property, plant and equipment.'

24. Some staff think that even though ‘shares of assets’ is the requirement that should prevail, the final standard should not indicate that the classification of those shares should be in accordance to the nature of the asset but state instead that ‘a party shall recognise, in accordance with applicable IFRSs its assets or its share of the assets it controls’.

25. Some other staff think, that removing the words ‘classified according to the nature of the asset’ from the requirement in ED 9.22 would result in less explicit requirements than the existing ones in ED 9 and IAS 31, and that ‘in practice’ parties to ‘joint operations’ would still keep on accounting and presenting its share of the assets based on the nature of the latter. These staff propose to present the share of an asset/liability according to the nature of the underlying asset/liability, however, shared assets/liabilities could be presented as a separate line item from the same fully controlled assets/liabilities of an entity.

Question 2

Does the Board agree with the proposed clarification of the accounting requirements in relation to the nature of the assets and liabilities to be recognised by the parties in ‘joint operations’ to be ‘shares of assets/liabilities’ instead of ‘rights’?

If so, which option does the Board prefer: (a) delete the guidance relating the classification of the share of assets to be recognised or (b) keep the guidance relating the classification of the share of assets according to their nature?

Difference between an entity recognising its share of assets, liabilities, revenues and expenses and proportionate consolidation

26. Many respondents to the Invitation to Comment to ED 9 questioned which is the difference between an entity accounting for its share of assets, liabilities, revenues and expenses and an entity accounting for its interest in a ‘joint operation’ using proportionate consolidation.

27. We think that in many cases there are no differences. There will be differences if parties agree to share some elements (eg revenues, profits, etc) in a different proportion from their interest share in the joint operation. For example, parties

might share some operational costs based on their share in the joint operation however they might agree to be entitled to revenues based on sales of inventory that they contribute to the arrangement. In that case, the parties should account for their share of the revenues based on the sales of the inventory contributed and not based on their interest share in the joint operation.

28. We think that we should provide in the application guidance an example in which the accounting of the interests in a 'joint operation' would differ if an entity accounted for its share of the assets, liabilities, revenues and expenses instead of accounting for its interests using proportionate consolidation.

Question 3
Does the Board agree to provide clarification in the final standard of instances where the accounting for a party's share in the assets, liabilities, revenues and expenses would differ from applying proportionate consolidation?