IFRS™

# AGENDA PAPER

IFRS Foundation Trustees

**11 January 2012** **Agenda paper 3Eii**

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**To:** David Sidwell, Chairman - Due Process Oversight Committee

**From:** Alan Teixeira

**Date:** 22 December 2011

**Re:** Response to letter from Business Europe

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In October Business Europe sent a letter to the Trustees raising concerns about several aspects of the due process followed when the IASB developed IFRS 11 *Joint Arrangements*. This report responds to the matters raised in that letter.

### Selection of companies participating in the outreach when developing the IFRS

During the development of IFRS 11 the staff and Board of the IASB undertook extensive outreach. The letter questions the selection process, saying that it is not transparent.

The objective of the outreach was to get a better understanding of concerns that had been raised to the IASB during the development of the proposals. The staff undertook this additional outreach with representatives from 41 companies. About half of the companies contacted had submitted comment letters on the exposure draft ED 9 *Joint Arrangements*.

The selection was skewed towards companies that were critical of the proposals. Around 13 per cent of the companies were approached at the suggestion of audit firms and about 25 per cent were contacted independently by the project staff. These companies were selected because of the relevance of joint arrangements in the industries in which they participate (eg the mining industry) or because joint arrangements feature prominently in their financial statements. In some cases they were approached because they had already made the transition from proportionate consolidation to the equity method and the staff wanted to learn more about their experience. Finally, 12 per cent of the participants did not send in a comment letter but contacted the project staff directly.

The companies covered a wide geographical spread: Europe 63 per cent, Asia-Pacific 5 per cent, Africa 5 per cent, North America 24 per cent and Global 3 per cent. The industries represented were Energy 27 per cent, Mining 15 per cent, Construction 10 per cent, Banking 7 per cent, Telecommunications 5 per cent, Aerospace & defence 5 per cent, Food & beverage 5 per cent, Representative bodies 5 per cent, Conglomerates 5 per cent and Other (pharmaceuticals, industrial engineering, advertising, environmental services, agriculture, automotive and healthcare) 16 per cent.

The outreach allowed the staff to access joint arrangement contracts and discuss how the new requirements would be applied. The project leader had many face-to-face and telephone meetings.

**Need for re-exposure**

The letter questions whether the Board should have considered re-exposure of ED 9. The arguments used by Business Europe relate mainly to the increase in guidance in the IFRS compared to the ED and the perception that the IFRS includes new requirements that were not exposed in the ED. These concerns are discussed in more detail below. However, in simple terms, the Board decided that re-exposure was not necessary because the IFRS respects the core principle presented by the ED for the recognition by parties of their interests in joint arrangements.

**More guidance in the IFRS than in the ED**

IFRS 11 includes more guidance than was exposed in ED 9. However, this was in response to comment letters on ED 9. The guidance provided in the IFRS aims to assist preparers to apply the core requirements of the IFRS, which deal with the classification of the arrangements. The fatal flaw reviews and extensive balloting processes did not generate any concerns about the guidance. None of the principles changed. In addition, the number of people and organisations included in the fatal flaw review was significantly greater than in our normal processes. The fatal flaw reviewers included many preparers.

**Introduction of new requirements**

The letter suggests that the term *other facts and circumstances* introduces new requirements to IFRS 11, which do not have a clear principle and for which constituents did not have a chance to follow their development.

The requirement in IFRS 11 to consider *other facts and circumstances* is aligned to the principle for parties to recognise their rights and obligations arising from the arrangements. These are not new requirements. ED 9 acknowledged the possibility that arrangements being accounted for using the equity method could end up being accounted for on a gross basis. The relevant paragraphs of ED 9 are as follows (emphasis added):

> 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 that it controls and its liabilities.
>
> BC11 Therefore, 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.**

No respondents expressed concerns about these statements. The change made from ED 9 to IFRS 11 is that the term *other facts and circumstances* was introduced as a convenient shorthand term.

The letter also refers to Illustrative Example 5, which was published along with IFRS 11 as an example that aims to *illustrate other facts and circumstances*. This is incorrect. Example 5 aims to illustrate that the contractual terms of the agreement between the parties are able to modify or reverse the effects that the legal form can have on the parties' rights and obligations. This is not something new introduced by IFRS 11. ED 9 had introduced this possibility in the following paragraphs (emphasis added):

> 6 Among the factors that a party considers in assessing the type of arrangement is the legal form of the arrangement. The form of the arrangement can affect the rights and obligations of the parties, but is not always the determining factor. For example, the shareholders of a limited liability company are not usually obliged to pay for expenses incurred by, and financing of, the company. However, **a contract** (such as a guarantee contract) **can negate the effect of limited liability.**
>
> BC6 Accounting for interests in joint arrangements in accordance with IAS 31 follows the form of an arrangement (ie the accounting can differ depending on whether a legal entity is established). The Board acknowledges that the form of an arrangement affects the rights and responsibilities of an entity. For example, an entity might transfer an asset that it owns into an entity that it controls with the effect that the owner has limited its liability in relation to that asset by using a legal structure. Equally, however, **an owner**

**could reverse the effects of that legal structure through guarantees or indemnities.**

### *Other facts and circumstances* is developed on the basis of a clear and understandable principle

As mentioned above, the letter states that *other facts and circumstances* does not reflect a clear principle. In IFRS 11 *other facts and circumstances* relates to the circumstances in which a party to a joint arrangement has interests in the assets and liabilities of the arrangement. IFRS 11 states:

> B31 When the activities of an arrangement are primarily designed for the provision of output to the parties, this indicates that the parties have rights to substantially all the economic benefits of the assets of the arrangement. The parties to such arrangements often ensure their access to the outputs provided by the arrangement by preventing the arrangement from selling output to third parties.
>
> B32 The effect of an arrangement with such a design and purpose is that the liabilities incurred by the arrangement are, in substance, satisfied by the cash flows received from the parties through their purchases of the output. When the parties are the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

This is not a 'new' principle for recognition of assets and liabilities in IFRSs. IFRIC 4 *Determining whether an Arrangement contains a Lease* gives similar economic reasons that give evidence of whether an arrangement is, or contains, a lease.[1]

### Companies will face implementation issues

The letter also mentions that companies will face implementation difficulties when applying the requirements relating to 'other facts and circumstances'. The main examples that are provided of implementation difficulties are:

#### *Additional information required*

In our view, the need for additional information for the recognition of assets and liabilities arising from joint operations should not be a major constraint, because the

[1] Relevant paragraphs in IFRIC 4 are paragraphs 9, BC30-BC39.

information required should already have been available to entities when accounting for those interests under the equity method.

*Contracts might need to change*

We think that this is a possibility if the parties think that their contracts do not reflect the rights and economic substance they thought sought. In that case, this could be a positive effect of the IFRS.

*Additional discussions with auditors about the classification*

The letter states that the new IFRS generates additional audit costs. This is acknowledged in the Effect Analysis. All new IFRSs imply implementation costs for constituents.

The letter also mentions that application costs will be particularly high for start-up companies with research and development or production activities. The letter suggests that these cost considerations justify retention of the equity method for some joint operations. The purpose of the reforms was to increase the usefulness of the information presented in relation to joint arrangements. Unfortunately the letter from Business Europe does not provide any analysis of decision-usefulness, which is the basis for the Board's decision. This concern was also not raised in Business Europe's comment letter responding to ED 9.

**Other matters**

The letter mentions that joint arrangements that are not structured in entities are joint operations. This is perceived as being a rule. This requirement has not changed from either IAS 31 or ED 9 and this aspect of the exposure draft did not cause major concerns to constituents responding to ED 9. This matter was not mentioned in the comment letter written by Business Europe in response to ED 9.

**Conclusion reached in the *Effect Analysis***

The letter also questions some of the conclusions reached in the Effect Analysis document; in particular, the expectation by the staff and Board that most 'jointly controlled entities' will be 'joint ventures' in accordance with IFRS 11.

The staff assessment has not changed. The staff have continued to discuss the new requirements with interested parties over the last few months. Their assessment remains that more jointly controlled entities will be joint ventures than joint operations. In addition, the staff assessment is that 'other facts and circumstances' will affect the classification of only very specific types of arrangements (only those designed as described in paragraphs B32 and B33 of IFRS 11). The purposes for which joint arrangements are established are many and the requirements in paragraphs B32 and

B33 relate to arrangements with a specific purpose that are designed in such a way that parties have rights to the assets, and obligations for the liabilities, of the arrangement.

For this specific type of arrangement, outreach was carried out with constituents in the oil and gas, mining, automotive and pharmaceutical industries. These industries will be some of the main industries affected.

In addition, all the major audit firms were also involved in all the stages of the development of IFRS 11.

BUSINESSEUROPE

THE DIRECTOR GENERAL

Trustees of the IFRS Foundation
IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

10 October 2011

Dear Sirs,

We write to you regarding due process issues with IFRS 11. Earlier this year, on 11 January 2011, we wrote to Sir David Tweedie to raise some concerns about the unclear role of staff papers and the fact that they are not formalised in the due process. In particular we raised the issue of the staff draft on Joint Arrangements and its related outreach for which we considered that it was not clear how companies participating in the outreach had been selected and which, we believed, could have resulted in unfair and unequal treatments. You will find enclosed a copy of the letter for ease of reference.

Now that our members are analysing IFRS 11 in view of its application, our concerns have materialised into implementation issues which are further explained in the appendix to this letter.

Firstly, we would like to explain the due process issues of IFRS 11, but not to discuss the technical merits of the decision that the Board took during the re-deliberation of ED 9 even if we have to refer to some technical decisions for illustrative purposes. Secondly, we would like to discuss the current due process which IFRS 11 was based on and to make proposals to improving it.

We trust that the Trustees will be able to play an active and constructive role in ensuring that such improvements indeed come about and would like to refer to the appendix for a more extensive discussion on these issues. We remain at your disposal should you wish to discuss this subject further.

Yours sincerely,

Philippe de Buck

## APPENDIX: DUE PROCESS ISSUES WITH IFRS 11

### Introduction

BUSINESSEUROPE raised some concerns about the unclear role of staff papers and the fact that they are not formalised in the due process in its letter of 11 January 2011 (enclosed). In particular it raised the issue of the staff draft on Joint Arrangements and its related outreach for which we considered that it was not clear how companies participating in the outreach had been selected and which, we believed, could have resulted in unfair and unequal treatments. Now that our members are analysing IFRS 11 in view of its application, our concerns have materialised into implementation issues which we explain in this letter. We also consider that the explanations that the Staff of the IFRS Foundation has given in its Project Summary and Feedback Statement of May 2011 and its Effect Analysis of July 2011 are not entirely convincing and that the development of IFRS 11 highlights due process issues that should be corrected.

We are also surprised to note that the above-mentioned two documents are disclaimed as representing the views "*of the staff who prepared the document[s]*" and that those documents "*do not purport to represent the views of the IASB and should not be considered as authoritative*". While we would acknowledge that those documents are not authoritative accounting literature, we have difficulty understanding why the explanations on the due process and the effect analysis, which are both of utmost importance for the IASB constituents, are disclaimed in such a way, especially bearing in mind that they are required by § 50 of the Due Process Handbook.

Therefore the purpose of this letter is twofold. Firstly we would like to explain the due process issues of IFRS 11, but not to discuss the technical merits of the decision that the Board took during the re-deliberation of ED 9 although we have to refer to some technical decisions for illustrative purposes. Secondly we would like to discuss the current due process which IFRS 11 was based on and to make proposals to improving it.

### ED 9 Background

In accordance with its due process, the Board published ED 9 (the ED) on Joint Arrangements in September 2007 and exposed it for comments during a 120 day period ending on 11 January 2008. The ED required Joint Arrangements to be classified and accounted for as follows[1] :

- Joint Operations, where each party should recognise the assets it controls and the liabilities it incurs;
- Joint Assets, where each party should recognise its share of the assets and the liabilities; and
- Joint Ventures, which should be accounted for using the equity method, because the parties did not have the rights to the individual assets and liabilities of the JV.

[1] ED9 §§ 21, 22 and 23.

## ED 9 Re-deliberation

In pages 9 and 10 of the above-mentioned Project Summary and Feedback Statement, the Staff explains that it did not consider it was necessary to re-expose any aspect of the proposals because the changes consisted merely in adding application guidance and narrowing the classes of joint arrangements from three to two. The staff also adds that it conducted outreach and field testing. We believe that this raises three issues:

(i) did the Board introduce new requirements in the application guidance?
(ii) were the outreach and field tests conducted in a transparent manner so that all the IASB constituents could openly express their opinions? and
(iii) was it correct not to re-expose the proposals?

### *(i) Introduction of new requirements*

When the Board prepared IFRS 11, we consider that it did not limit itself to reducing the number of classes of joint arrangements as said above but it also introduced a very fundamental concept for the classification of Joint Arrangements, that is the consideration of "other facts and circumstances" (§§ 12 and 13 and B15 (b) (iii)). Furthermore application guidance has grown from one paragraph in ED 9 to 37 paragraphs in IFRS 11.

By adding the "other facts and circumstances" criterion, the overall (convergence) aim to eliminate the choice of either applying the proportionate consolidation or the equity method of accounting was, softened. IFRS 11, by presenting several examples (in particular Example 5), tries to illustrate when other facts and circumstances lead to the determination of a joint operation even though the arrangement is conducted through a separate legal entity with equal residual rights for each venture partner, whereas under current guidance (IAS 31) it is accounted for as a jointly controlled entity and either proportionately consolidated or accounted for using the equity method of accounting.

While the Board concluded in May 2009 that "all relevant facts and circumstances" needed to be considered to assess whether an arrangement is a joint operation or a joint venture and that there is a rebuttable presumption that an arrangement is a joint venture when it consists of an entity, the consequences of this - to a certain extent - obvious statement was first clarified via an Education Session in early 2011 and eventually became fully clear only upon publication of the standard in May 2011. All constituents did not have an opportunity to follow the development of this important newly-introduced concept by reading the general IFRS Updates or similar publications, and accordingly did not have a chance to share their understanding and concerns about this substantial change in guidance.

Since the new "other facts and circumstances" criterion is not based on a clear and understandable principle and, accordingly, provides only insufficient and unclear guidance, interpretations of these facts and circumstances will vary significantly, leading to divergence in practice and a corresponding loss of overall comparability. We may take this matter up directly with the IASB at a later date.

We are also very surprised about the apparent lack of an impact assessment for those companies that currently account for their arrangements as joint ventures under IAS 31 using the equity method of accounting and that will now be required to account for these arrangements as joint operations under IFRS 11.

These companies will face implementation issues including, but not limited to the following:

- Companies will be required to obtain necessary information in respect of joint operations for a complete set of financial statements (including note disclosures) while only having to provide more limited information if they are accounted for using the equity method. Those companies that utilise IFRS financial statements for internal analysis, controlling and management purposes (monthly reporting, management information systems), and consequently base their transactional systems on IFRS, will have to fully integrate joint operations in their systems on a line by line basis.
  We do not believe that the additional information provides significant benefits to users while making preparation processes more complicated, longer and expensive for preparers.
- The preparation of this additional information may not have been contractually agreed and would require renegotiation of contracts with partners.
- Additional discussions with auditors and regulators about the classification of joint arrangements and treatment of insignificant joint operations will have a negative impact on preparer processes, closing timelines and costs. In addition, audit fees will increase due to the additional audit work required if a company is proportionately consolidated.

The costs described above are especially critical for start-up companies with research and development or production activities that are completely integrated into the supply chains of the jointly controlling partners. Usually, these companies operate on a break-even level or slightly above. Equity accounting is comparatively easy, quick and not expensive under these circumstances. The equity income is negligible, the carrying amount of the investment is calculated once and will remain fairly unchanged on the basis of the break-even level. Under the new guidance, such companies do not only face the burden of full external reporting requirements but also the potential consequences on management reporting as described above. This will lead to a disproportionately high amount of accounting staff and systems in these companies and therefore increase costs.

When requiring preparers to assess the facts and circumstances the Board limits such assessment to joint arrangements that are structured in the form of a separate vehicle but it does not require the same assessment for joint arrangements that are not structured in the form of a separate vehicle. The Board justifies that discrepancy in BC27 by saying that such possibility would be "very rare" and on grounds of simplification. We consider that, in doing so the Board has created a rule-based requirement.

We also would like to understand how the Staff derived the following conclusion on page 19 of the July 2011 Effect Analysis:

*"We expect that most 'jointly controlled entities' in IAS 31 will be 'joint ventures' in accordance with IFRS 11. This is because we expect that, in most cases, if the*

*arrangement is structured in a separate vehicle that can be considered in its own right, neither the terms of the contractual arrangement nor the consideration of other facts and circumstances will reverse the rights and obligations that the legal form of the separate vehicle confers on the parties.*

*However, the contractual arrangement between the parties and, when relevant, other facts and circumstances, might establish that the parties have rights to the assets and obligations for the liabilities held in the separate vehicle in which the arrangement has been structured. In this case the former 'jointly controlled entity' in IAS 31 could be a 'joint operation' in accordance with IFRS 11."*

As a result of this assessment, the IASB did not pursue any further consultation with entities which, in the future, would have to account for their arrangements as joint operations rather than as joint ventures, but instead only focused on the other direction of the change. Given our observation that some of our member companies are affected by the new proposals to change from equity accounting to proportionate consolidation, we would like to understand how the conclusion was made that the overall impact of the new guidance for these cases could be neglected in the impact study.

***(ii) Transparency of the outreach***

While we favour (and will always strongly recommend) outreach, hearings, field tests and similar procedures because they facilitate achieving high quality financial reporting that enhances the communication between preparers and users, we consider that (as said in our letter of 11 January 2011 quoted above) that staff draft and related outreach and similar procedures should be carried out in connection with the due process and in a transparent manner, thus allowing all the IASB constituents to take part in such activities. In respect of the elaboration of IFRS 11, the problem was that outreach was conducted at the discretion of the Staff and we cannot determine whether the Board had adequately considered the remarks of its constituents before and during the outreach process.

On page 10 of the Project Summary and Feedback Statement it states that the Staff met with 40 respondents out of 111 (36%) which had submitted a comment letter. The Staff also met with other interested parties in several industries (natural resources, real estate, aerospace and defence, telecom and banking). However the Staff does not discuss how it selected the respondents and the companies it contacted. The Staff did not publish any progress report on its contacts with its selected constituents and there were no comments thereon in the IASB Update until January 2011 when the Board decided to provide an overview of the main requirements of the forthcoming IFRS in an education session as mentioned above. Our members who participated in the outreach told us that the documents that they received from the Staff were marked "DRAFT" and some others were classified as confidential. While we understand that at times there may be restrictions on what is disclosed to the public, we consider that the Board should have informed its constituents about the development of the standards resulting from the outreach much earlier than in January 2011, which was far too late because, at that date, the publication of the IFRS was quite close.

### *(iii) Re-exposure of the proposals*

The Project Summary and Feedback Statement of May 2011 concludes that "it was not necessary to re-expose any aspects of the proposals" because the main changes consisted of application guidance, adjustments of the terminology and the reduction of joint arrangements from three to two.

As explained in sections (i) and (ii) above, ED 9 had almost no application guidance and the Board issued a substantive application guidance, following on from an obscure outreach process. The Board also did not consider that the introduction of the "other facts and circumstances" criterion would considerably impact the reporting of several entities while we have demonstrated under section (i) that it does. This should have, in our opinion, warranted a re-exposure to test whether those requirements would be practicable for all constituents and not with a limited number of constituents selected at the discretion of the Staff.

### Way forward and conclusions

We strongly recommend that the Trustees perform a review of the standard development process for IFRS 11 and determine whether the requirements of the due process were appropriately considered during the development of the standard. In our opinion, particular focus should be put on the determination as to whether affected constituents were appropriately consulted on the impact of the suggested changes given the complete change in guidance compared to IAS 31. As far as we are concerned, we do not believe that the Board has entirely complied with its due process because it did not post the changes to ED 9 on its website (contrary to the Due Process Handbook § 45) but only published a presentation during an education session that took place far too late in January 2011. Moreover, the outreach procedure was not transparent as explained above under section (ii) above.

While the Board and the Staff may have acted in good faith, we consider that the issues that we have raised in this letter demonstrate that the current due process is no longer adequate for the current complexity of financial reporting, as even a single phrase may have consequences on the reporting of corporates. More importantly, substantial changes and / or increases in the volume of the Application Guidance should be a reason for re-exposure, possibly with a short consultation period, because the guidance is an integral part of an IFRS that the auditors constantly refer to in order to determine whether the preparers have complied with the standard. The review of the Application Guidance also allows one to test whether the future IFRS would be practicable.

Finally we highly recommend that any staff draft, outreach or field test procedure that is carried out after preparing an Exposure Draft of a Standard should be made available to all the IASB constituents via the IASB Website in order to allow them to take a position thereon. Since we understand that the Trustees are currently reviewing the IASB strategy, we respectfully recommend that they take the above proposals into consideration.

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