IFRS

STAFF PAPER

12–13 November 2013

IFRS Interpretations Committee Meeting

IASB: May, Sep 2013

Project	**Accounting for Interests in Joint Operations structured through Separate Vehicles**		
Paper topic	Consultation of the IFRS Interpretations Committee by the IASB		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. At its September 2013 meeting, the IASB discussed the joint operator's accounting in its separate IFRS-financial statements for an interest in a joint operation that is housed in a separate entity.[1] This was in response to a request from a national standard-setter (the 'NSS') to review how such investments are reported in the separate IFRS-financial statements of the joint operator when the joint operation is housed in a separate entity.

2. As a result of this discussion, the IASB asked the staff to undertake additional consultations to identify real life examples of difficulties in practice to help the IASB to assess the magnitude of accounting issues in the separate IFRS-financial statements of the joint operator.[2] This consultation should also include the IFRS Interpretations Committee (the 'Interpretations Committee').

3. For ease of reference, Staff Paper 12 for the September 2013 IASB ('Staff Paper 12') meeting is attached to this Staff Paper.

[1] See Staff Paper 12 presented at the September 2013 IASB meeting: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2013/September/12-Joint%20Arrangements.pdf

[2] http://media.ifrs.org/2013/IASB/September/IASB-Update-September-2013.pdf

Purpose and structure of the Staff Paper

4. The purpose of this Staff Paper is to inform the Interpretations Committee about the IASB's discussion so that it can identify, in its discussion at the November 2013 meeting, examples of difficulties and other information that helps the IASB in assessing the magnitude of the accounting issue that it is discussing.

5. The Staff Paper therefore outlines the issue by:

   (a) summarising the accounting requirements in IFRS 11 *Joint Arrangements* that are relevant for this issue;

   (b) explaining the request from the NSS;

   (c) summarising the staff analysis for the September 2013 IASB meeting; and

   (d) summarising the IASB's discussion at the September 2013 meeting.

6. The Staff Paper also asks a question to the Interpretations Committee.

The issue

IFRS 11

7. Paragraph 20 of IFRS 11 sets out the accounting requirements for a joint operator's interest in a joint operation. A joint operator recognises, in relation to its interest in a joint operation:

   (a) its assets, including its share of any assets held jointly;

   (b) its liabilities, including its share of any liabilities incurred jointly;

   (c) its revenue from the sale of its share of the output arising from the joint operation;

   (d) its share of the revenue from the sale of the output by the joint operation; and

   (e) its expenses, including its share of any expenses incurred jointly.

8. The interest in a joint operation is accounted for by a joint operator in the same manner in its consolidated and separate IFRS-financial statements. This is the case irrespective of whether the joint operator is structured through a separate vehicle or not (see paragraphs B15 and following of IFRS 11).

Request from the NSS

9. The NSS is concerned about the accounting set out above for the separate IFRS-financial statements of a joint operator. It thinks that joint operators should account, in their separate IFRS-financial statements, for their interests in joint operations that are housed in separate vehicles (whose legal form confers separation between the parties and the vehicle) in the same way as for their interests in subsidiaries. This is:

   (a) at cost in accordance with IAS 27 *Separate Financial Statements*; or

   (b) at fair value in accordance with IFRS 9 *Financial Instruments*.

10. The NSS bases its recommendation on three arguments:

   (a) an inconsistency between IFRS 11 and IAS 27 (see the following paragraphs for further details);

   (b) duplication of information between consolidated IFRS-financial statements and separate IFRS-financial statements. The duplication of the information that is already reported in the consolidated IFRS-financial statements in the separate IFRS-financial statements is of no benefit for users of separate IFRS-financial statements; and

   (c) the risk possibility of double taxation of income in jurisdictions that determine taxable income of entities on the basis of separate IFRS-financial statements. In such jurisdictions, there is a risk that the separate vehicle and the joint operator pay taxes on the same income. The NSS argues that explaining the accounting required for joint operations and the adjustments made in determining taxable income to the tax authorities may be challenging.

11. According to the NSS, IAS 27 and IFRS 11 are inconsistent with respect to the relevance that a separate vehicle has for the accounting for an interest in a subsidiary and a joint operation:

    (a) IAS 27 requires that a parent accounts for its interests in subsidiaries at cost or in accordance with IFRS 9. Subsidiaries are defined as entities that are controlled by another entity (see Appendix A of IFRS 10 *Consolidated Financial Statements* and paragraph 5 of IAS 27) and the definition of separate vehicle includes entities (see Appendix A of IFRS 11). In other words, the existence of an entity is sufficient to require a parent to account for its interest in the entity instead of the assets and the liabilities inside of the entity.

    (b) IFRS 11 requires that a party to a joint arrangement accounts for its interest in the joint venture using the equity method and for its interest in a joint operation using the accounting outlined in paragraph 7 of this Staff Paper. The classification as a joint venture or a joint operation depends upon the rights and obligations of the parties to the arrangement (see paragraph 14 of IFRS 11) and a separate vehicle (whose legal form confers separation between the parties and the vehicle) is only an indicator for a joint venture. In other words, the existence of a separate vehicle is insufficient to determine the accounting in the separate IFRS-financial statements of the joint operator.

12. The NSS gave the following example to illustrate its argument:

> IAS 27 requires a parent to account for its interest in a fully-owned subsidiary that is designed for the provision of output to the parent (ie the parent has rights to all the economic benefits of the subsidiary) at cost or in accordance with IFRS 9 in its separate IFRS-financial statements.
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> IFRS 11 instead requires that joint operators account for their investments in such entities by recognising its share in the assets and the liabilities held by the entity. A joint arrangement in which the parties have agreed to purchase substantially all the output produced by the arrangement (ie the parties have contractual rights to the output) at a price that guarantees that the

arrangement will be able to settle all the liabilities incurred in the production of that output (ie the parties have contractual obligations for the liabilities of the arrangement) is classified as a joint operation (see paragraphs B29–B32 of IFRS 11).

13. The NSS does not think that the difference between control and joint control justifies the fundamental difference in accounting in the separate IFRS-financial statements.

14. On the contrary, the NSS considers the recognition of an interest in an entity the weaker form of representation of an investment in the financial statements compared to the recognition of (shares in) the assets and the liabilities held by the entity. On this basis, the NSS considers it counterintuitive, if joint control as a weaker form of influence compared to control results in a stronger form of representation in the financial statements.

Staff analysis and recommendation for the September 2013 IASB meeting

15. The staff analysis in Staff Paper 12 disagreed with the argument of the NSS about the inconsistency between IFRS 11 and IAS 27.

16. The purpose of Staff Paper 12 was to demonstrate that requiring a joint operator to account for its interest in a joint operation using the equity method and not accounting for any rights or obligations from the arrangements that caused it to be a joint operation would be inconsistent with the accounting by a parent.

17. The example used in Staff Paper 12 was not the fact pattern provided by the NSS. The authors of Staff Paper 12 wanted to use a simpler, less controversial, example where the joint operation was established through specific agreements that gave rights to assets as a point of comparison with the accounting by a parent entity. The staff analysis points out that a joint operator recognises its interest in the assets held and liabilities of the separate vehicle. However, the recognition of these shares in the assets and liabilities is not the result of proportionate consolidation. It is instead the result of the joint operator's accounting for own rights and obligations. On this basis the joint operator must also account for the

shares it holds in the joint operation entity, in the same way a parent accounts for its shares in a subsidiary in its separate financial statements.

18. In Staff Paper 12 this was illustrated by the example of an entity that holds a specialised asset. The total cost of the asset of CU100 is financed by paying CU10 and borrowing the remaining CU90. Each investor in the entity owns half of the shares in the entity, for which each of them has paid CU5 to the entity (giving a total equity of CU10). A contract relates to the governance of the entity that makes it a joint arrangement. Each investor also has a finance lease in place that gives each investor control of the rights to half of the capacity of the specialised asset for the whole life. The investors determine that the arrangement is a joint operation.

19. The Staff Paper explains that the joint operator accounts for its shares in the entity at cost or in accordance with IFRS 9 at fair value. In addition, the finance lease is recognised in accordance with IAS 17 *Leases*.

20. Staff Paper 12 considered this accounting to be an appropriate representation of the relevant rights and responsibilities of the joint operator and found it to be consistent with the requirements in IFRS 11. In this context, it made reference to the following principles in IFRS 11 (see paragraph 20 of Staff Paper 12):

    (a) accounting for an interest in a joint operation by the joint operator in accordance with IFRS 11 differs from proportionate consolidation. A joint operator does not 'consolidate' but accounts for its rights to the assets and obligations for the liabilities relating to the joint operation. Correspondingly, the accounting guidance for joint operations does not contain references to elimination of balances or investments. For example, a loan to a wholly owned subsidiary is presented as a loan in the separate IFRS-financial statements of the parent and is eliminated on consolidation in the group IFRS-financial statements. However, a joint operation structured through a separate vehicle is not part of the group and therefore a joint operator does not consolidate it.

(b) accounting for a share of any assets held jointly may not necessarily mean recognising the share of the joint assets, classified according to the nature of the asset. This is because the issue was discussed in the June 2009 IASB meeting wherein the staff presented two options:

    (i) to require a joint operator to present the share of an asset or a liability according to the nature of the underlying asset or liability; or

    (ii) the final Standard should not indicate that the classification of the share of assets should be in accordance with the nature of the asset but state instead that a party shall recognise, in accordance with the applicable IFRSs, its assets or its share of the assets that it controls.

    The IASB finally concluded that a party to a joint operation should recognise its assets or its share of any assets in accordance with the IFRSs applicable to the particular assets (see paragraph BC39 of IFRS 11). The rights to the assets and obligations for the liabilities arise from the contractual arrangements between the joint operator and the joint operation and among the joint operators. Consequently, the assets and the liabilities recognised by a joint operator are those that arise from the contractual arrangements.

(c) to further substantiate the discussion in (b), paragraph 21 of IFRS 11 states that a joint operator shall account for the assets, liabilities, revenues and expenses relating to its interest in a joint operation in accordance with the IFRSs that are applicable to the particular assets, liabilities, revenues and expenses. IFRSs do not explicitly consider the recognition and measurement of part of an asset or a shared obligation. Hence, recognition of a share of an asset or a liability, classified according to the nature of the asset or the liability, is not in accordance with paragraph 21 of IFRS 11.

Discussion at the September 2013 meeting of the IASB

21. At its meeting in September 2013 the IASB did not discuss the accounting set out in Staff Paper 12. The discussion focused more on the likelihood that there might be different approaches being taken in practice, and that some entities are likely to be applying a proportionate accounting approach.

22. At the meeting, other staff indicated that they held a view of the accounting requirements for an interest in a joint operation that was different to the approach set out in Staff Paper 12. That alternative view was that IFRS 11 overrides the notion of a separate vehicle for joint operations.

    (a) Under this approach, the joint operator does not account for its interest in a joint operation that is structured through a separate vehicle at cost in accordance with IAS 27 or at fair value in accordance with IFRS 9. In other words, the joint operator does not account for an equity investment. Instead, the joint operator accounts for its share in the assets held by the separate vehicle that houses the joint operation or in the liabilities incurred by it. This reading is also the basis for the concern of the NSS.

23. This view (View 2) is supported by the following arguments:

    (a) the classification of a joint arrangement as either a joint venture or a joint operation is central to IFRS 11. It is a binary classification. A joint arrangement is either one or the other; it cannot be part joint venture and part joint operation (see paragraphs 6 and BC25 of IFRS 11). Accordingly, if a single framework agreement governs more than one activity, each activity is assessed and classified separately (see paragraphs 18 and IE17 and following of IFRS 11).

    (b) the binary classification of joint arrangements as either joint ventures or joint operations is a difference between IFRS 11 and the Exposure Draft that preceded it (see paragraphs 4 and IE3−IE8 of the Exposure Draft *Joint Arrangements* ('ED 9')). ED 9 included the possibility of a 'hybrid' approach, which involved the party to a joint arrangement accounting for its (direct) rights and obligations to the assets and the

liabilities of the separate vehicle that houses the joint arrangement and the equity accounting for the residual. The IASB rejected this approach after considering the feedback from the comments letters on ED 9 (see paragraphs BC35, BC70(c) and BC77 of IFRS 11).

(c) when a joint arrangement is not structured through a separate vehicle, it is classified as a joint operation (see paragraph B16 of IFRS 11). When a joint arrangement is, however, structured through a separate vehicle (for example, because it is housed in an entity), the parties to the joint arrangement are required to assess their rights to the assets of the joint arrangement and their obligations for the liabilities of the joint arrangement (see paragraphs 17 and B19 and following of IFRS 11). If the rights and obligations that the party has are sufficient to overcome (override) the effects of the separate legal entity, then the party classifies its interest in the joint arrangement as a joint operation (see paragraph B23 of IFRS 11). If the party's rights and obligations are insufficient, then it classifies its interest as a joint venture. This involves the following consequences:

(i) if the party's rights and obligations are insufficient to attain the classification as a joint operation, then the party will account for its interest in the joint arrangement by using the equity method (see paragraph 24 of IFRS 11). It will also account for any specific contractual rights and obligations that it might have from agreements, such as the joint arrangement agreement, because they are in addition to its rights and obligations that arise from its shareholding in the separate vehicle that houses the joint arrangement. IAS 17, for example, is one of the Standards that apply in accounting for the joint operator's rights to use the assets held by the separate vehicle that houses the joint arrangement.

(ii) if the party's rights and obligations are sufficient to achieve the classification as a joint operation, then IFRS 11 requires a joint operator to account for its shares in the assets held by the separate vehicle that houses the joint operation and in

the liabilities that this separate vehicle incurred (see paragraphs 20–22 of IFRS 11).

(d) by recognising its share in the assets and the liabilities of the separate vehicle that houses the joint operation, the joint operator accounts for its interest in the joint operation as if it is an extension of itself. It is equivalent to an entity having an overseas branch, which, although it might have the status of a separate legal entity in the overseas country, it is nevertheless still part of the entity for accounting purposes. The notion, however, that the joint operator accounts for its interest in the joint operation as an extension of itself is inconsistent with the recognition of an interest in the shares of the separate vehicle that houses the joint operation. This is because, logically, an entity cannot recognise in its financial statements a balance with itself.

(e) the notion that the interest in a joint operation is an extension of the joint operator is consistent with the fact that the accounting for an interest in a joint operation is the same in both consolidated IFRS-financial statements and the joint operator's separate IFRS-financial statements (see paragraphs 26(a) and BC38 of IFRS 11). The accounting for joint operations does not respect the boundaries of the legal entities involved. This is because the legal boundaries are 'undone' by the joint arrangement. This is not consolidation of the separate vehicle that houses the joint operation. Instead it is accounting for all the assets and the liabilities of the joint operator.

(f) the reading set out in Staff Paper 12 questions the distinction between joint ventures and joint operations. This is because the reading appears to result in no difference in the accounting for an interest in a joint venture and an interest in a joint operation. This may be illustrated by the example in paragraph 18 of this Staff Paper. Irrespective of whether the joint arrangement is classified as a joint venture or a joint operation, the party to the joint arrangement accounts for its interest at cost or in accordance with IFRS 9. In addition, this party would also account for

its right to use the specialised asset held by the entity that houses the joint arrangement as a finance lease by applying IAS 17.

(g) Illustrative Example 3 of IFRS 11 makes clear in paragraph IE21 of IFRS 11 that joint operators recognise their shares in the assets held by the entity that houses the joint operation (see paragraphs IE14–IE28 of IFRS 11). The specific assets in Example 3 are property, plant and equipment and cash. We think that only View 2 results in the recognition of the joint operators' shares in the cash held by the entity that houses the joint operation (Entity M). We do not think that the approach set out in Staff Paper 12 (View 1) would lead to this accounting. No Standard other than IFRS 11 would lead to the recognition of shares in the cash held by Entity M. We think IFRS 9 instead would result in the joint operators recognising obligations to fund the joint operation as liabilities or rights to receive cash from the joint operation as assets.

(h) when changing from the equity method to accounting for assets and liabilities in respect of its interest in a joint operation as part of the adoption of IFRS 11, the entity applies the following procedures (see paragraphs C7 and C8 of IFRS 11) (emphasis added):

> When changing from the equity method to accounting for assets and liabilities in respect of its interest in a joint operation, an entity shall, at the beginning of the immediately preceding period, *derecognise* the investment that was previously accounted for using the equity method and any other items that formed part of the entity's net investment in the arrangement in accordance with paragraph 38 of IAS 28 (as amended in 2011) and recognise its share of each of the assets and the liabilities in respect of its interest in the joint operation, including any goodwill that might have formed part of the carrying amount of the investment.
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> An entity shall determine its interest in the assets and liabilities relating to the joint operation on the basis of its

rights and obligations in a specified proportion in accordance with the contractual arrangement. An entity measures the initial carrying amount of the investment at the beginning of the immediately preceding period on the basis of the information used by the entity in applying the equity method.

24. This transition accounting applies irrespective of whether the joint operation is structured through a separate vehicle or not. Replacing the investment that was previously accounted for using the equity method by the assets and the liabilities that were disaggregated from the carrying amount of this investment conforms with View 2 and conflicts with the accounting set out in Staff Paper 12.

25. As a result, the IASB decided to undertake additional consultation, as expeditiously as possible, with national accounting standard-setters and accounting firms to identify real life examples of difficulties in practice to help it assess the magnitude of accounting issues in the separate IFRS-financial statements of the joint operator. This would help the IASB to assess whether there are any issues that need to be addressed.

Questions for the Interpretations Committee

Questions for the Interpretations Committee
1. Is the accounting for interests in joint operations that are structured through separate vehicles in separate IFRS-financial statements (expected to be) a prevalent issue in practice? 2. What are your views on the two different readings of IFRS 11 (View 1, that is set out in Paper 12 from the IASB meeting in September 2013, and View 2 as outlined in this Staff Paper)? What observations did you make with respect to these two different readings? 3. What are the examples from practice in which preparers face difficulties in applying IFRS 11 to the accounting for interest in joint arrangements that are structured through a separate vehicle?