STAFF PAPER

March 2013

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	Elimination of gains arising from a transaction between a joint venturer and its joint venture		
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Introduction

1. In January 2013, the IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify the accounting for a transaction between a joint venturer (an entity) and its joint venture. The request describes a circumstance in which the amount of gains to eliminate from the transaction exceeds the amount of the entity's interest in the joint venture. Specifically, the submitter requested that the Interpretations Committee should clarify whether:

   (a) the gain from the transaction should be eliminated only to the extent that it does not exceed the carrying amount of the entity's interest in the joint venture; or

   (b) the remaining gain in excess of the carrying amount of the entity's interest in the joint venture should also be eliminated and if so, where it should be eliminated against.

2. This agenda paper is organised as follows:

   (a) Summary of the issue

(b) Staff analysis

(c) Agenda criteria assessment

(d) Annual improvements criteria assessment

(e) Outreach activities to date

(f) Staff recommendation

(g) Appendix A─Submission.

Summary of the issue

3. An entity is a joint venturer in a joint venture in accordance with IFRS 11 *Joint Arrangements*. Consequently, the entity accounts for its interest in the joint venture using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*.

4. The entity enters into a lease agreement with the joint venture, whereby the entity leases its fixed assets to the joint venture and the lease is classified as a finance lease in accordance with IAS 17 *Leases*.

5. In the submitter's example, the fact patterns are assumed as follows:

- Each joint venturer paid CU100[1] in exchange for acquiring 50 per cent of the ownership shares of the newly established joint venture; thus, the carrying amount of the investment in the joint venture recognised in each joint venturer's financial statements equals CU100 and the equity of the joint venture totals CU200.
- In the finance lease transaction, the carrying amount of the fixed assets to be derecognised from the entity's financial statements equals CU50,000 and the carrying amount of the lease receivable to be initially recognised in the entity's financial statements (ie the fair value of the fixed asset at the transaction date) equals CU90,000;

[1] In this staff paper, currency amounts are denominated in 'currency units' (CU).

thus the entity records a gain of CU40,000 in its separate financial statements.

6. When the entity prepares its financial statements on a consolidation basis using the equity method, paragraph 28 of IAS 28[2] would normally be applied to account for how to partially eliminate the gain of CU40,000; paragraph 28 of IAS 28 requires that gains and losses resulting from 'downstream' transactions between an entity and its joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the joint venture, eliminating the investor's share in the joint venture's gains resulting from the transactions.

7. On the basis of this paragraph, the amount to be eliminated in the example above would be CU20,000 (CU40,000 × 50 per cent). However, because this amount exceeds the carrying amount of the entity's interest in the joint venture, which is CU100, the question arises as to whether the whole amount of CU20,000 should be eliminated, or the amount should be eliminated only to the extent that it does not exceed the carrying amount of the entity's interest in the joint venture, leaving CU19,900 (CU20,000 – CU100) not to be eliminated.

8. The submitter notes two views:

   (a) **View A—**the gain from the lease transaction is eliminated only to the extent that it does not exceed the carrying amount of the entity's interest in the joint venture; and

   (b) **View B—**all of the entity's share of the gain from the lease transaction is eliminated.

[2] In this staff paper, paragraph numbers of IAS 28 denote those of IAS 28 as amended in 2011, unless otherwise indicated.

View A*—the gain from the lease transaction is eliminated only to the extent that it does not exceed the carrying amount of the entity's interest in the joint venture*

9. Proponents of View A argue that paragraphs 38 and 39 of IAS 28 can be analogised to the transaction in issue. They observe that:

- paragraph 38 of IAS 28 states that if an entity's share of losses of an associate or joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses; and
- paragraph 39 of IAS 28 states that after the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture.

10. Even though these paragraphs relate to an entity's accounting in a circumstance where its associate or joint venture is making losses, they argue that the same logic can be applied; so that if an entity's share of the gain from this lease transaction exceeds its interest in the joint venture, the entity discontinues eliminating its share of gain.

11. Consequently, in the submitter's example, the amount to eliminate would be CU100 out of CU20,000.

View B*—all of the entity's share of the gain from the lease transaction is eliminated*

12. Proponents of View B argue that analogising paragraph 38 and 39 of IAS 28 is not appropriate, because elimination of gains from 'downstream' transaction has a different characteristic from the recognition of additional losses by an associate or joint venture.

13. They also cite paragraph 28 of IAS 28, which states that gains and losses resulting from ‘upstream’ and ‘downstream’ transactions between an entity and its associate or joint venture are recognised in the entity’s financial statements only to the extent of unrelated investors’ interests in the associate or joint venture.

Staff analysis

Applicability of paragraphs 38 and 39 of IAS 28

14. We note that proponents of View A base their argument on the fact that paragraph 38 and 39 of IAS 28 is similar to the submitter’s case, in that these paragraphs provide guidance on the accounting when the entity’s interest in the joint venture reduces to zero.

15. We think that to analogise to these paragraphs in the submitter’s case, the rationale behind these paragraphs should also be applicable to the case; however, we do not find any similarity in this respect.

16. In paragraphs 38 and 39 of IAS 28, we think that the reason why the entity is required to discontinue the recognition of losses when the entity’s interest in the associate or joint venture reduces to zero is because the entity would not bear any further losses exceeding the carrying amount of its investment in the associate or joint venture[3]. However, we think that in the case of the elimination of gains and losses from a ‘downstream’ transaction, discontinuing the elimination of gains when the entity’s investment reduces to zero could not be based on the same reason that underlies those paragraphs.

17. Consequently, we do not think that it is appropriate to analogise to paragraphs 38 and 39 of IAS 28 in the submitter’s case, because we note

[3] Paragraph 39 of IAS 28 states that after the entity’s interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture.

that these paragraphs are only relevant to the case in the sense that they deal with a situation in which the carrying amount of the entity's interest in the joint venture reduces to zero.

18. We do not support View A.

Applicability of paragraph 28 of IAS 28

19. We note that paragraph 28 of IAS 28 clearly states that gains and losses resulting from 'downstream' transactions between an entity and its joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interest in the joint venture.

20. We are not aware of whether this paragraph was meant to apply to the situation in which the investment reduces to zero. However, because we find no economic reason to apply different accounting in that situation, we think that this paragraph as it stands can be applied to the submitter's case.

21. Consequently, we think that the entity's share of the gain from the lease transaction should be eliminated in full, even if the amount to eliminate exceeds the carrying amount of the entity's interest in the joint venture.

22. We support View B.

Question 1 for the Interpretations Committee
Does the Interpretations Committee agree that the entity's share of the gain from the lease transaction should be eliminated in full, even if the amount to eliminate exceeds the carrying amount of the entity's interest in the joint venture? If not, why not and how does the Interpretations Committee think it should be accounted for?

Corresponding entry for the remaining gains to eliminate in excess of the carrying amount of the investment in the joint venture

23. If the Interpretations Committee agrees with View B, we note that the question would arise as to how the entity should present the corresponding entry for the remaining gains to eliminate that are in excess of the amount of the investment in the joint venture.

24. We think that we can consider two methods as follows:

- **Method 1**—accounting in the same way as for deferred income; and
- **Method 2**—accounting in the same way as for deduction of the related asset (ie in our case, the lease receivable).

25. We think that the reason why IAS 28 requires gains and losses from 'downstream' transactions between an entity and its associate or joint venture to be eliminated is because such gains and losses are regarded as unrealised until the associate or joint venture realises the gains and losses through its operation. In this respect, we think that Method 1 would reflect the characteristic of the eliminated gains, because deferred income would represent the unrealised nature of the eliminated gains. The advantage of Method 1 would also be that the portion of eliminated gains exceeding the entity's interest in the joint venture is clearly shown in the financial statements; it would thus help users of the financial statements to easily identify such eliminated gains.

26. On the other hand, the argument for Method 2 would be that it is not appropriate to present such eliminated gains as deferred income, because they do not meet the definition of a liability as defined in the *Conceptual Framework for Financial Reporting*.

27. In addition, if we consider that the consequence of recognising the gain was originally to recognise the lease receivable, then eliminating the entity's share of the gain against the lease receivable would provide symmetry with the recognition of the gain.

28. However, Method 2 would result in treating the lease receivable as part of the entity's net investment in the joint venture, which would be inconsistent with the definition of 'the interest in a joint venture' described in paragraph 38 of IAS 28. The paragraph reads as follows [emphasis added]:

> If an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture, the entity discontinues recognising its share of further losses. **The interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the joint venture.** For example, an item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension of the entity's investment in that associate or joint venture. Such items may include preference shares and long-term receivables or loans, but do not include trade receivables. Trade payables or any long-term receivables for which adequate collateral exists, such as secured loans. (…)

29. In 'downstream' transactions, an entity's share of the gains from a transaction with its joint venture is eliminated against the entity's interest. Consequently, if the remaining gain is eliminated against the lease receivable, it would indicate that the lease receivable is regarded as part of the entity's net investment. However, the lease receivable could not be part of the entity's net investment, because the lease receivable is not an item "for which settlement is neither planned nor likely to occur in the foreseeable future" as described in paragraph 38 of IAS 28.

30. In addition, Method 2 would not provide useful information on the lease receivable, because the lease receivable that is deducted by the eliminated gains exceeding the entity's interest in the joint venture neither shows the actual transaction amount of the lease receivable nor

represents the amount in respect of the entity's related interest in the joint venture.

31. Furthermore, we note that by deducting the gain against the lease receivable, we would be eliminating part of the **transaction** that gave rise to the gain, whereas the requirement in IAS 28 is to eliminate part of the **gain** arising from the transaction.

32. On the basis of the analysis above, we think that Method 1 would be the appropriate accounting, because deferred income shows the nature of the eliminated gains (ie unrealised gains) and it would enable the users of the financial statements to readily obtain information about the amount of eliminated gains in excess of the entity's interest in the joint venture.

Question 2 for the Interpretations Committee
If the Interpretations Committee agrees with View B in Question 1, does the Interpretations Committee agree that the entity should record deferred income as the corresponding entry for the gains eliminated in excess of the carrying amount of the investment in the joint venture? If not, why not and how does the Interpretations Committee think it should be accounted for?

Analysis on the submitter's further comment

33. The submitter provided a further comment. The submitter says that:

- some practitioners question whether the entity, having a 50 per cent of ownership interest in the joint venture, retains substantial risks and rewards associated with the leased asset from a consolidate perspective. Accordingly, they raise a question about whether the leased asset still qualifies as a finance lease, because the consolidated group (the reporting entity) has not surrendered substantially all the risks and rewards incidental to ownership of the asset; and

- a further question can be raised as to whether the classification of operating and finance lease differs depending on whether the lease transaction is viewed on a single-entity or consolidated basis (ie when the equity method is applied).

34. We think that a lease transaction should be treated in the same way as a sale transaction when applying paragraph 28 of IAS 28, although a lease transaction is not specifically described as an example of 'upstream' transaction and 'downstream' transaction in that paragraph. Paragraph 28 of IAS 28 is as follows [emphasis added]:

> Gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture. 'Upstream' transactions are, for example, sales of assets from an associate or a joint venture to the investor. **'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture**. The investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated.

35. In the case of a sale transaction, the criteria in IAS 18 *Revenue* would be first applied to determine whether revenue should be recognised, and if the transaction is between an entity and its joint venture, paragraph 28 of IAS 28 would be applied to eliminate the entity's share of gains and losses.

36. Similarly, we think that the criteria in IAS 17 should be first applied to determine whether a lease transaction qualifies as a finance lease, and subsequently paragraph 28 of IAS 28 should be applied to eliminate the entity's share of gains and losses if the lease transaction is between an entity and its joint venture.

37. We think that this analogy can also be supported by the fact that one of the criteria for revenue recognition in IAS 18 and the criteria for classification of lease in IAS 17 use the concept of risks and rewards.

38. We, therefore, think that just as revenue recognition is not affected by the fact that the seller is a joint venturer and the buyer is a joint venture, the classification of operating leases and finance leases would not be dependent on whether the lease transaction is entered into between unrelated separate entities or between a joint venturer and a joint venture.

Question 3 for the Interpretations Committee
Does the Interpretations Committee agree with the staff analysis of the submitter's further comment?

Agenda criteria assessment

39. We assess the submission against the agenda criteria of the current *Due Process Handbook* as follows.

The Interpretations Committee should address issues:

(a) that have widespread effect and have, or are expected to have, a material effect on those affected;

(b) where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and

(c) that can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework for Financial Reporting.

In addition:

(d) The issue should be sufficiently narrow in scope that it can be addressed in an efficient manner by the Interpretations Committee, but not so narrow that it is not cost-effective for the Interpretations

Committee and interested parties to undertake the due process that would be required when making changes to IFRSs.

(e) The solution developed by the Interpretations Committee should be effective for a reasonable period of time. Accordingly, the Interpretations Committee would not normally develop an Interpretation if the topic is being addressed in a forthcoming Standard. However, this does not prevent the Interpretations Committee from acting on a particular matter if the short-term improvements can be justified.

40. We note that there are divergent views in published guidance provided by some accounting firms.

- Firm A supports View A;
- Firm B provides an example supporting View A;
- Firm C suggests that either View A or View B can be chosen as an accounting policy (in the case of View B, the corresponding entry is deferred income); and
- Firm D prefers View B (with the corresponding entry being deferred income), but considers View A as acceptable alternative; ie, it is an accounting policy choice.

41. We think that financial reporting would be improved through the elimination or reduction of the diverse accounting.

42. On the basis of the staff analysis, we also think that this issue can be resolved efficiently within the confines of existing IFRSs and the issue is sufficiently narrow in scope.

Outreach activities to date

43. We sent out a request for information to the IFASS to help assess the Committee's agenda criteria, which was still outstanding (due 1 March 2013) when this agenda paper was completed. Specifically, we asked:

Q1. Is the fact pattern described in the submission common or relevant in your jurisdiction?

Q2. If you answered "yes" to Q1, what is the prevalent approach in your jurisdiction to account for elimination of gains described in the submission, and why? Also, if View B is the prevalent accounting in your jurisdiction, where is the corresponding entry recorded for the remaining gains to be eliminated that exceeding the carrying amount of the entity's interest in the joint venture, and why?

Q3. Do you see any diversity in practice in that accounting? If so, please explain how and why the accounting is diversified.

Q4. With regard to the further comments raised by the submitter, have you encountered the same concerns? If so, how have the concerns been addressed?

We will present any update at the 2013 March Interpretations Committee meeting.

Staff recommendation

44. On the basis of the staff analysis, we think that in a lease transaction between an entity and its joint venture, all of the entity's gain from the lease transaction should be eliminated when the amount of the gain to eliminate exceeds the carrying amount of the entity's interest in the joint venture. We also think that the corresponding entry for the remaining gain to eliminate in excess of the carrying amount of the entity's interest in the joint venture should be recognised as deferred income.

45. This is because the entity should apply paragraph 28 of IAS 28, which states that gains and losses resulting from 'downstream' transactions between an entity and its joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interest in the joint venture.

46. Unless the results of the outreach cause us to change our view, on the basis of the agenda criteria assessment, we recommend that the Interpretations Committee should add this issue to its agenda because we note that there are divergent views in practice If the Interpretations Committee agrees, we will bring back proposals to the next meeting on how we think IAS 28 should be amended to address this issue.

Question 4 for the Interpretations Committee
Does the Interpretations Committee agree with the staff recommendation?

Appendix A—Submission

(to be added)