STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	IFRS 11 *Joint Arrangements*		
Paper topic	Consideration of some common joint arrangement structures		
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Introduction

1. As mentioned in Agenda Paper 5, at its January 2014 meeting, the IFRS Interpretations Committee (the Interpretations Committee) requested the staff to provide further analysis on implementation issues relating to IFRS 11 *Joint Arrangements*.

2. In response to the request, this Agenda Paper considers the application of IFRS 11 to some common joint arrangement structures[1]. Particularly, we will address some joint arrangements that are structured in the form of so-called 'project entities'[2] in various industries and jurisdictions.

3. We observe that although such joint arrangements that we referred to as 'project entities' have common features, there are also some variations to fact patterns depending on the type of the joint arrangements. However, in this paper, we will only consider a case that is assumed to have more common features. This is because although we have noted some variations to the common features we will address, we are still in the progress of identifying the relevant variations. We therefore provide a list of those variations that have been identified so far in

[1] We will address an issue of implication for accounting within separate financial statements at a future meeting, which is another request made by the Interpretations Committee at its January 2014 meeting.

[2] We use the term 'project entities' on the basis of the cases collected from our outreach request carried out in July 2013 and some examples that we were informed of during additional outreach afterwards.

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Appendix A. Our objective is to bring an analysis of these variations to the next meeting to contrast with the analysis presented in this paper.

Staff analysis

Application to the case of 'project entities'

4. In this analysis, we examine how our conclusions in Analyses 1 to 5 as noted in Agenda Paper 5A would be applied to the joint arrangements that are structured in the form of so-called 'project entities' with regard to assessing 'other facts and circumstances'.

5. We assume that when we consider an example of 'project entities' below, (1) the legal form of the separate vehicle does not give the parties rights to the assets, and obligations for the liabilities, relating to the joint arrangement; and (2) the terms of the contractual arrangement does not specify that the parties have rights to the assets, and obligations for the liabilities, relating to the arrangement.

6. We will consider a joint arrangement where the parties (Parties A and B) set up a separate vehicle (Entity C) to construct an item of property, plant and equipment (PPE) and produce an output (Output D)[3] which has the following project life-cycle:

   - Parties A and B find suitable land for construction and third party customers.
   - Parties A and B make pre-sale agreements for Output D with customers.
   - Parties A and B secure financing for the operation of the joint arrangement.
   - Entity C, a separate vehicle, is set up for the purposes of undertaking a joint arrangement.
   - Entity C subcontracts its activities to Parties A and B or third-party contractors.

[3] For the purpose of the analysis, we think Output D could be either the item of PPE itself, once it has been constructed or it could be a product that is generated from the item of PPE.

- Entity C[4] acquires the land.
- Entity C[4] completes the construction of the item of PPE.
- Entity C[4] sells Output D to third-party customers.
- Entity C transfers the cash from the sale of Output D to Parties A and B after paying all liabilities of Entity C..
- Entity C is liquidated after the period of warranties given to customers

7. We will assume that Entity C has the following features that are typically found in many 'project entities':

Structure of Entity C

(a) (**Feature A**) It has only thin capitalisation.

(b) (**Feature B**) It has no workforce of its own (its activities are subcontracted to either Parties A and B or third parties).

(c) (**Feature C**) During the life of Entity C, the assets and liabilities of Entity C are mainly the cash received from customers' prepayments and the construction in progress, account receivables and account payables.

(d) (**Feature D**) It is a limited-life entity that has been set up for a single project.

(e) (**Feature E**) Revenues are generated from sales of Output D to third-party customers.

Involvement of Parties A and B with Entity C

(f) (**Feature F**) Parties A and B are responsible for delivering the services to the ultimate customers[5].

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[4] Because Entity C subcontracts its activities to Parties A and B or third-party contractors, the actual activity would be performed by the subcontractors.

[5] For example, Parties A and B carry out the following activities:

- select and evaluate the constructability of the land;
- negotiate the acquisition of the land;
- negotiate the financing of the operation and the relating financial guarantees; and

(g) (**Feature G**) Creditors of Entity C have right of recourse against Parties A and B only if all the claims against Entity C are finally unsuccessful; Parties A and B are severally or jointly liable for all the debts of Entity C.

(h) (**Feature H**) The customers of Entity C are obtained through Parties A and B's commercial resources (eg personnel, websites, classified ads, trade name).

(i) (**Feature I**) Parties A and B finance Entity C for any loss or cash needs of Entity C, for example when there is budget overruns or delivery delays.

(j) (**Feature J**) As a legal requirement, non-completion risk is covered by a performance bond issued by Entity C that is counter-guaranteed by Parties A and B (ie Entity C cannot enter a performance bond without backing of those parties).

(k) (**Feature K**) Any major litigation arising during or after the operations of Entity C are managed by Parties A and B's legal services. Moreover, such litigations are often accompanies by direct legal actions against Parties A and B.

Examination 1: do Parties A and B have 'inferred' rights and obligations?

8. In Analysis 1 of Agenda Paper 5A, we noted how the parties to the joint arrangement have 'inferred' rights to the assets of the joint arrangement and 'inferred' obligations for the liabilities of the joint arrangement.

9. The parties to the joint arrangement have 'inferred' rights to the assets of the joint arrangement when they:

(a) have **rights** to economic **benefits** (for example, 'output') of the assets of the joint arrangement ; and

(b) have **obligations** to acquire those economic benefits and therefore assume **risks** relating to those economic benefits (for example, the risks relating to the 'output').

- choose the contractors and manage the operations (commercialisation, administrative function).

10. The parties to the joint arrangement have 'inferred' obligations for the liabilities of the joint arrangement when they:

(a) are, through 'inferred' rights to the assets of the joint arrangement, substantially the only source of cash flows that:

(i) can ensure the settlement of the liabilities of the joint arrangement; and

(ii) can continue the operation of the arrangement; and

(b) settle the liabilities of the joint arrangement **on a continuous basis**.

11. We will examine Features A to K by assessing against the criteria for 'inferred' rights and 'inferred' obligations as noted above.

Consideration of Features A to E

12. We first note that **Features A to D** (ie thin capitalisation, no workforce, type of assets and liabilities and a limited-life entity) do not affect the parties' rights to economic benefits of the assets of Entity C and obligations to acquire those economic benefits. We therefore think that these features would not create 'inferred' rights to the assets of Entity C.

13. **Feature E** (ie 'revenues are generated from sales of Output D to third party customers') needs to be considered together with the fact that the cash from the sale of Output D is transferred to Parties A and B after paying all liabilities of Entity C, which indicates that Parties A and B are entitled to the net cash amount from the sale of output. According to the criteria noted in Analysis 1 of Agenda Paper 5A, these features would suggest that the parties have rights to 'net' economic benefits of the assets of Entity C and assume 'net' risks relating to those economic benefits. Consequently, we think that Parties A and B would not have 'inferred' rights to the assets of Entity C.

Consideration of Features F to K

14. **Feature F** (ie Parties A and B are responsible for delivering the services to the ultimate customers) would not mean that they can have access to the assets of

Entity C or Output D. This is because Parties A and B are involved with the activities of Entity C through a subcontract with Entity C and therefore would be in the same position as third-party subcontractors. Accordingly, we think that this feature does not indicate that Parties A and B have its share of the economic benefits of the assets of Entity C.

15. **Feature G** (ie Entity C has a primary obligation for its liabilities) would suggest that Parties A and B do not provide a continuing cash flow to Entity C, which, in substance, could settle the liabilities of Entity C on a continuing basis. According to the criteria noted in Analysis 1 of Agenda Paper 5A, if the parties do not settle the liabilities of the joint arrangement on a continuing basis, they would not have 'inferred' obligations for those liabilities. Accordingly, we think that this feature indicates that Parties A and B do not have 'inferred' obligations for the liabilities of Entity C.

16. **Feature H** (ie Entity C's customers are obtained through Parties A and Parities B' commercial resources) does not relate to the parties' rights to the assets and obligations for the liabilities, relating to Entity C. This feature therefore would not affect the assessment of whether Parties A and B have 'inferred' rights to assets and 'inferred' obligations for the liabilities, relating to Entity C

17. **Feature I** (ie Parties A and B finance Entity C for any loss or cash needs of Entity C) indicates that the parties can provide substantially all the cash flows for Entity C and therefore settle the liabilities of Entity C. This is because it means that when Entity C needs cash for its operation, Parties A and B should provide funds to Entity C. This would meet some of the criteria to create an 'inferred' obligation. However, according to the criteria noted in Analysis 1 of Agenda Paper 5A, 'inferred' obligation is not independent of 'inferred' right. Therefore, we think that unless Parties A and B have 'inferred' rights, this feature alone would not create their 'inferred' obligations.

18. As for **Features J and K** (ie non-completion risk and litigation risk), we note that these risks are similar to the risks inherent in the role of a guarantor. These features therefore do not indicate that Parties A and B settle the liabilities of Entity C on a continuing basis. Accordingly, we think that Parties A and B do not have 'inferred' obligations for the liabilities of Entity C.

Examination 2: does the close involvement of Parties A and B with Entity C lead to the creation of 'inferred' rights and obligations?

19. Although we noted in Examination 1 above that the individual specific fact patterns do not create 'inferred' rights and 'inferred' obligations, we consider whether all the fact patterns, when taken into account as a whole, that Parties A and B are closely involved with Entity C would create 'inferred' rights and 'inferred' obligations.

20. In this regard, we note that IFRS 11 states that close involvement of parties to the joint arrangement in the operation of the joint arrangement does not necessarily explain the economic substance of the joint arrangement. Paragraph BC43 of IFRS 11 states that:

> BC43 The Board believes that the accounting for joint arrangements should faithfully reflect the rights and obligations that the parties have in respect of the assets and liabilities relating to the arrangement. In that respect, the Board observes that the activities that are the subject of different joint arrangements might be operationally very similar, but that the contractual terms agreed by the parties to these joint arrangements might confer on the parties very different rights to the assets, and obligations for the liabilities, relating to such activities. Consequently, **the Board believes that the economic substance of the arrangements does not depend exclusively on whether the activities undertaken through joint arrangements are closely related to the activities undertaken by the parties on their own, or on whether the parties are closely involved in the operations of the arrangements. Instead, the economic substance of the arrangements depends on the rights and obligations assumed by the parties when carrying out such activities. It is those rights and obligations that the accounting for joint arrangements should reflect.** (emphasis added)

21. Paragraph BC43 of IFRS 11 suggests that the fact that the parties to the joint arrangement are closely involved in the operation of the joint arrangement would not mean that the joint arrangement has no economic substance. In this sense, we think that the features that indicate Parties A and B's close involvement with Entity C would not imply that Entity C has no economic substance. We therefore do not think that close involvement by the parties can be used to argue that Parties A and B have rights to the assets and obligations for the liabilities, relating to Entity C.

22. On the basis of our analysis above, we think that Parties A and B would not have 'inferred' rights to the assets and 'inferred' obligations for the liabilities, relating to Entity C because the features of Entity C do not create such rights and obligations.

Examination 3: Consistency with principles in IFRS 10

23. In developing this paper, we consulted some stakeholders and they questioned whether the concept of 'rights and obligations' that would be used in the assessment of the classification of a joint arrangement required by IFRS 11 would be consistent with the concept of 'risks and rewards' used in assessing control of an investee required by IFRS 10 *Consolidated Financial Statements.* Specifically, they questioned whether a joint arrangement would be classified as a joint operation rather than a joint venture if the concept of 'risks and rewards' in IFRS 10 were applied to the assessment of the classification of the 'project entities' under IFRS 11. This is because they think that the parties to the joint arrangement in the case of 'project entities' would have 'overall' risks and rewards relating to the separate vehicle.

24. We do not think that the criteria for the classification of the joint arrangement in IFRS 11 are intended to be in line with the criteria for assessing control of an investee in IFRS 10. We note that IFRS 10 provides such criteria to determine whether an investor has control of the investees, whereas the criteria for the classification of the joint arrangement in IFRS 11 does not relate to determining whether the parties to the joint arrangement have joint control of the separate vehicle.

Staff recommendation

25. On the basis of our analysis, we think that the requirements in IFRS 11 can be applied consistently to a common type of joint arrangement, so-called 'project entities' in assessing 'other facts and circumstances if the 'project entities' have the same features as noted in our analysis. However, taking into account the fact that stakeholders have divergent views regarding the assessment of 'other facts and circumstances', we recommend that the Interpretations Committee should consider adding illustrative examples to IFRS 11.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff analysis that:
   (a) a common type of joint arrangement, so-called 'project entities' would not be classified as a joint operation if they have the same features as noted in this paper?
2. Does the Interpretations Committee agree with the staff recommendation that:
   (a) Illustrative examples should be added to IFRS 11?

Appendix A—A list of variations to common features

As noted in the section of Introduction in this paper, we have observed some variations to the common features that we considered in the analysis of this paper. We are still in the progress of identifying the relevant variations. Our objective is to bring an analysis of these variations to the next meeting to contrast with the analysis presented in this paper. The variations to the common features in this paper that have been identified so far are as follows:

- (**Variation 1**) Parties A and B construct an item of PPE on third-party customers land (ie they do not acquire the land).
- (**Variation 2**) During the life of Entity C, the assets and liabilities of Entity C are mainly the cash received from customers' prepayment, account receivables and account payables (ie there is no 'construction in progress').
- (**Variation 3**) Parties A and B assures the supervision of the activities of Entity C.
- (**Variation 4**) Parties A and B directly guarantee the completion of performance by Entity C (ie they do not counter-guarantee the performance bond issued by Entity C).
- (**Variation 5**) Output D is purchased by only one third party customer.
- (**Variation 6**) Output D is highly tailored to the customer's requirements.
- (**Variation 7**) Parties A and B undertake the same joint activity in another jurisdiction without creating a separate vehicle such as Entity C.
- (**Variation 8**) the roles of joint activities are split sequentially between Parties A and B (ie Party A is only involved with the first part of the process and then Party B is only involved with the second part of the process)