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*.

This Staff Paper is a copy of Staff Paper 12 presented at the September 2013 IASB meeting. This paper is presented as additional information in support of Staff Paper 11 about the issue of Accounting for Interests in Joint Operations structured through Separate Vehicles for the November 2013 IFRS Interpretations Committee meeting.

STAFF PAPER

September 2013

IASB Meeting

Project	Joint Arrangements		
Paper topic	**The separate financial statements of a joint operator**		
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Introduction

1. In May 2013, the IASB agreed with the staff's recommendation to amend IAS 27 *Separate Financial Statements* by proposing allowing an entity to measure its investment in a subsidiary, associate or joint venture using the equity method in its separate financial statements. We plan to expose that proposal later this year.

2. However, before we do so, we are asking the IASB to review the requirements in IFRS 11 *Joint Arrangements* as they relate the accounting for an interest in a joint operation by a joint operator in its separate financial statements.[1] This is in response to a request from a national standard-setter to review how such investments are reported in the separate financial statements of the joint operator when the joint operation is housed in a separate entity.

IFRS 11

3. IFRS 11 sets outs 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 as follows:

[1] IFRS 11 defines a joint operator as a party to a joint operation that has joint control of that joint operation.

4. A joint operator shall recognise 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.

5. The interest in a joint operation is accounted in the same manner in the consolidated and separate financial statements of a joint operator. This is the case whether the joint operation is structured through a separate vehicle or not.

The issue brought to the IASB

6. The national standard-setter (NSS) is concerned about the accounting in the separate financial statements of a joint operator for 'joint operations' when the joint operation is housed in a separate vehicle (whose legal form confers separation between the parties and the separate vehicle). The NSS asserts that there are three problems with the IFRS 11 requirements for the separate financial statements of the joint operator: an inconsistency with IAS 27; duplication of information between consolidated financial statements and separate financial statements; and the possibility of double counting of income for tax purposes.

7. The NSS provided the following comments to us:

   (a) *Inconsistency with IAS 27.* According to IAS 27 investments in subsidiaries are accounted for at cost or in accordance with IFRS 9 in all circumstances. In other words, according to IAS 27, the existence of a separate vehicle is sufficient to decide the accounting for the investment in the SFS of a parent. According to IFRS 11 the existence of a separate vehicle is not a sufficient indicator to decide the classification of a joint arrangement.

The NSS used the following example to highlight why they think it is inconsistent.

> A fully-owned subsidiary, which is designed for the provision of output to the parent (ie the parent has rights to all the economic benefits of the assets of the subsidiary), according to IAS 27, is recognised in the separate financial statements of the parent at cost or in accordance with IFRS 9. According to IFRS 11, a party to an arrangement that is structured through a separate vehicle, in which the parties have agreed to substantially purchase 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 a joint operation (see paragraphs B29–B32 of IFRS 11). A joint operator in such joint operation would account for its interest in accordance with paragraph 20 of IFRS 11 (ie it will recognise its assets and its liabilities in respect of its interest in the joint operation in its separate financial statements).
>
> It is unclear why the same fact pattern leads to different accounting requirements and that the outcome seems counterintuitive, considering that the stronger the level of control (ie control as against joint control), the weaker the representation (ie accounting for an investment as against accounting for the underlying assets and liabilities).

(b) *Duplication of information between consolidated financial statements and separate financial statements*. The NSS thinks that the information provided in the separate financial statements would not be useful to users, because it will be a duplication of the information that was already reported in the consolidated financial statements. Separate financial statements offer information that integrates the financial information that was provided by consolidated financial statements. In their view, it is not clear what the reason is for making an exception in the case of joint operations.

(c) *Possibility of double counting of income for tax purposes.* In jurisdictions, where separate financial statements prepared in accordance with IAS 27 are used for determining taxable income, there is a possibility of the same income getting assessed in the hands of both the separate vehicle and the joint operators. Explaining the accounting and the adjustments made in determining taxable income to the tax authorities can become challenging.

Staff analysis and recommendation

8. The fundamental issue is the consistency between the accounting by a parent and the accounting by a joint operator. The matters of duplication and double counting for income tax purposes are addressed later in the paper.

9. Before we assess the specific fact pattern sent to us, we think that it is helpful to consider four simple cases.

Simple case

Fact pattern

10. **Common facts:** In all of the examples, the investee holds a specialised asset that cost CU100 which it financed by paying CU10 and borrowing the remaining CU90. Investee has equity of CU10. The investee is a company.

11. **Parent-subsidiary relationship:** The parent holds all of the shares in the subsidiary for which it paid CU10 to the subsidiary.

    In example 1A the parent uses the asset in its group, using its control of the governing body to make that decision on an on-going basis. Rental payments are made from the parent to the subsidiary to service the debt.

    In example 2A the parent and subsidiary enter into a finance lease agreement for the life of the asset with payments designed to meet the principal and interest obligations of the subsidiary.

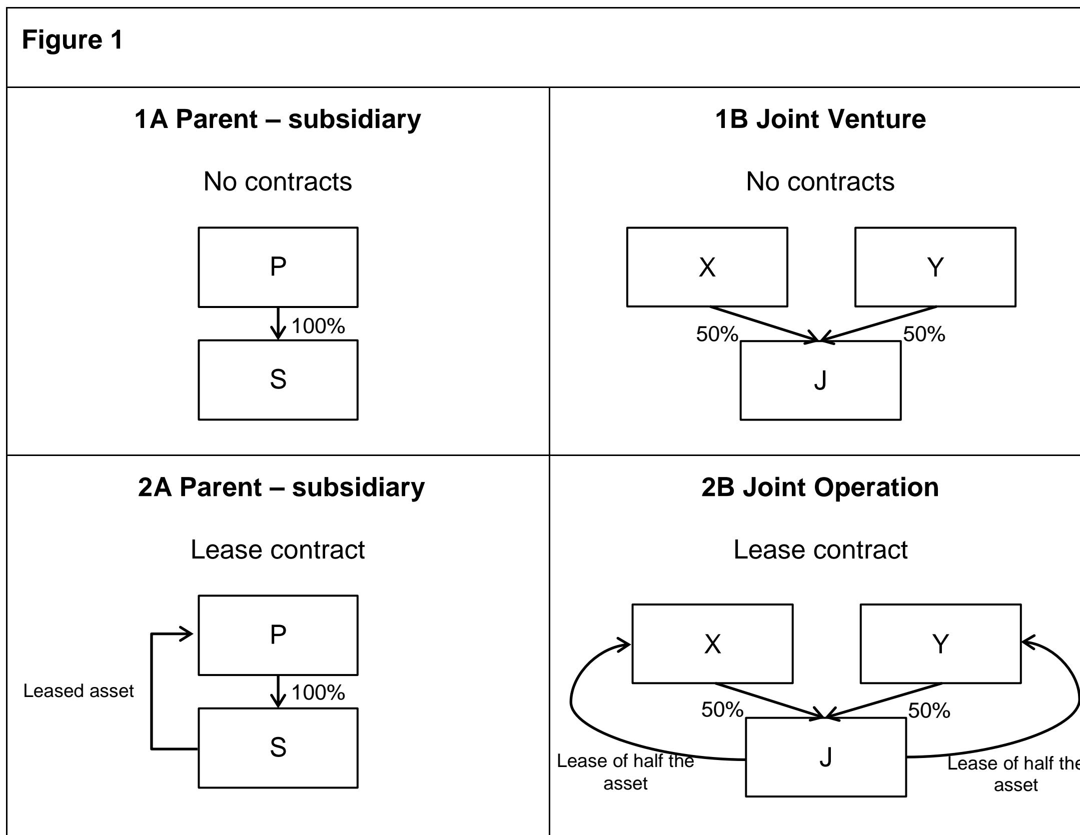
12. **Joint arrangement relationship:** Each investor holds half of the shares in the investee, for which they paid CU5 to the investee (giving total equity of CU10).

    In example 1B there is a contract in place relating to governance that makes it a joint arrangement. However, there are no other agreements in place that affect the corporate structure. The investors assess the indicators in B15(b) and conclude the arrangement is a joint venture. The joint venturers, by way of their governance agreement, each use the asset half of the time and each make rental payments to the investee to service the debt.

    In example 2B the investors also each have 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 of its life.[2] The investors determine that the arrangement is a joint operation.

[2] The lease contract might be a finance lease or an operating lease, depending on the nature of the asset. This is because IAS 17 refers to 'an asset'. Whether the lease is a finance lease or an operating lease may depend on whether the interest is in a ''separate' asset or whether the rights to the whole (underlying) asset are not able to be separated. In this example we assume that the asset is legally divisible and the joint operator has a lease over the whole of one of the separate assets.

13. Figure 1 provides a pictorial representation of the four cases.



14. Please note that these examples are not intended to be interpretative in any way. For example, we assert that case 2B is a joint operation. It will not always be the case that the existence of a finance lease means a joint arrangement is a joint operation. The purpose of this paper is to demonstrate the accounting once that classification determination has been made.

Accounting

15. In the examples the accounting in the separate financial statements would be as shown in Figure 2.

Figure 2	
1A Parent – subsidiary The shares are carried at cost or FV, (or using the equity method if the proposed change proceeds)	**1B Joint Venture** The shares are carried at cost or FV, (or using the equity method if the proposed change proceeds)
2A Parent – subsidiary The shares are carried at cost or FV, (or using the equity method if the proposed change proceeds) The finance lease is recognised in accordance with IAS 17.	**2B Joint Operation** The shares are carried at cost or FV, (or using the equity method if the proposed change proceeds) The finance lease is recognised in accordance with IAS 17.

16. The staff think the accounting is uncontroversial for cases 1A, 1B and 2A. There seems to be some uncertainty about case 2B, because IFRS 11 focuses on the activities, and assets and liabilities, of the joint operation but not the accounting for any instrument held by a joint operator in the entity in which the joint operation is housed. The Board may wish to amend IFRS 11 or IAS 27 to refer to the ownership instruments a joint operator holds in an entity that is a joint operation.

17. We think it is important to emphasise that in a **parent-subsidiary** relationship any contracts between the two are reported in the separate financial statements of the parent. For example, a loan from a parent to a subsidiary would be recognised and reported in the separate financial statements of the parent even though the loan would be eliminated in the group financial statements. In the fact pattern we have provided here, if the parent sells all of the shares in the subsidiary in case 1A the parent has no further interest in the specialised asset. In case 2A if the parent sells the shares the parent will continue to have access to the specialised asset because of the lease. In other words, the rights of the parent in 1A and 2A are not the same. The different financial reporting outcomes reflect these differences.

18. We think the accounting as we have described it is an appropriate representation of the relevant rights and responsibilities of the joint operator. We also consider the accounting to be consistent with the requirements in IFRS 11.

19. We considered the following principles from IFRS 11 which are important in the present context.

    (a) Accounting for a party's interest in a joint operation 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 arrangement. Furthermore, the accounting guidance does not contain references to elimination of balances or investment. For example, a loan to a wholly owned subsidiary is presented as a loan in the separate financial statements of the parent and eliminated on consolidation in the group 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 issue was discussed in the June 2009 meeting of the IASB wherein the staff presented two options:

        (i) one option was to require a joint operator to present the share of an asset/liability according to the nature of the underlying asset/liability; and

        (ii) the other option was that 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 applicable IFRSs its assets or its share of the assets 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. [IFRS 11 paragraph BC39]

The rights to the assets and obligations for the liabilities arise from the contractual arrangements between the joint operator and the joint operation, and the joint operators inter se. Consequently, the assets and liabilities recognised by a joint operator are those that arise from the contractual arrangements.

(c) To further substantiate the discussion in (b) above, 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 applicable to the particular assets, liabilities, revenues and expenses. IFRSs do not explicitly consider the recognition and measurement of a part of an asset or a shared obligation. Hence, recognition of share of asset/liability, classified according to the nature of the asset/liability is not in accordance with paragraph 21 of IFRS 11.

Analysis of the issue brought to the IASB

20. The fact pattern provided to us by the NSS describes what we consider to be the equivalent of Cases 1A and 2B, except that instead of a lease agreement it is an agreement related to consumption of the output of the investee. The respondent asserts that their cases depict the same fact pattern. We do not agree. In the parent-subsidiary example provided to us there is no contractual or other arrangement that creates separate rights.

21. In contrast, a joint arrangement that is housed in an entity can only be a joint operation if there is an arrangement in place that creates separate rights and responsibilities that would lead to the recognition of assets, liabilities, revenues or expenses. It is important that these rights and responsibilities are recognised by the joint operator. The only way an arrangement can be a joint operation is when the arrangements are sufficiently clear that they create separate assets and liabilities of the joint operators.

22. If a parent and subsidiary have equivalent agreements in place, for example that oblige the parent to consume all of the asset (or take all of the output), the parent should be recognising the related assets and liabilities.

23. We understand the point the NSS makes about the parent appearing to have more power than a joint operator yet unless there is a lease or other specific contract or arrangement in place it does not report the underlying assets of the subsidiary, in the examples the specialised asset. However, having an on-going ability to direct an asset of a subsidiary while the parent owns the shares in the subsidiary is not the same as having a right to that asset for the purposes of the separate financial statements.

24. The NSS has requested that we amend IFRS 11 so that in case 2B the joint operator would account only for its ownership interest in the joint operation and not the assets and liabilities that result from the other contractual arrangements. The staff do not support this request. To do so would undermine the concept that an entity recognises its assets and liabilities. It would mean that a parent that lends money to a subsidiary would recognise its investment in the subsidiary and the loan receivable, in its separate financial statements yet a joint operator would not report any assets or liabilities that result from equivalent contracts.

25. We think that the issue is not how to account for the rights and responsibilities resulting from contracts between the joint operator and the joint operation, but how to account for the investment in equity of the joint operation.

Other matters

Duplication (information usefulness)

26. The NSS also raises the issue of duplication of information. We think from the examples provided above that the accounting as we have described in figure 2 is an appropriate depiction of the differing rights and responsibilities of the joint operator (and parent in examples 1A and 1B)—see the explanation in paragraph 17.

Double counting for tax purposes

27. We do not believe there is any double counting of revenues or expenses, in the examples we have used. In cases 1A and 2A, the parent/joint operator is assumed

to need to pay rent to cover the loan repayments of the subsidiary/joint operation. Even if the parent/joint operator pays the amounts directly to the lender, presumably the parent/joint operator recognises an expense for rental payments. The subsidiary/joint operation would recognise the rental payments as revenue and have interest and depreciation expenses, which offset over the asset life.

28. In the situations where there is a lease in place the parent/joint operator recognises depreciation on the leased asset and interest on the lease payments. The subsidiary/joint operation recognises the interest revenue and interest expense.

Staff recommendation

29. We thought the accounting requirements in IFRS 11 and IAS 27 were clear. However, we cannot ignore the fact that several parties have asked us to clarify the accounting, particularly around the difference between proportionate consolidation and the joint operation accounting described in IFRS 11. We therefore recommend that the IASB do two things.

30. Firstly, we are about to propose an amendment to IAS 27 to allow the use of the equity method to account for the equity interest in a subsidiary, associate or joint venture. We should use the opportunity to clarify that these options are also available for an equity interest in an entity that houses a joint operation. Doing so will make explicit the accounting requirements for such interests.

31. Secondly, we also think it would be helpful to include in the exposure draft some illustrative examples demonstrating the accounting (ie debits and credits) for interests in joint operations. In particular, we have heard some requests for examples where the joint operator's percentage of equity investment differs from their interest in a particular asset or a revenue stream. These examples would help emphasise that the accounting for assets and liabilities is not a proportional consolidation. We can decide whether to publish illustrative examples in the light of the feedback we receive.

Staff recommendations and questions for the IASB

Does the IASB agree to

(a) propose an amendment to IAS 27 to clarify that a joint operator must account for any interest in the equity of an entity that houses a joint operation, measuring that investment at cost, fair value or using the equity method; and

(b) expose, with the proposed amendments to IAS 27, illustrative examples for joint operations?