STAFF PAPER

July 2014

IFRS Interpretations Committee Meeting

Project	IFRS 11 *Joint Arrangements*
Paper topic	Consideration of a specific type of joint arrangement structure

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Introduction

1. As mentioned in Agenda Paper 2, at its March 2014 meeting, the IFRS Interpretations Committee (the Interpretations Committee) requested the staff to provide an analysis of a specific type of joint arrangement structure that has different features from the ones identified in Agenda Paper 5B for the March 2014 Interpretations Committee meeting.[1] These specific joint arrangement structures are sometimes referred to as 'project entities'.

2. In response to this request, this Agenda Paper identifies some key features of a specific type of joint arrangement structure that have not been considered in the paper to the March 2014 Interpretations Committee meeting. Most of these features were included in the list of variations to the example of Agenda Paper 5B for the March 2014 Interpretations Committee meeting, provided in Appendix A of that paper. The joint arrangement structure to be discussed in this paper is established for a bespoke construction project for delivery of a single product or service to a single customer. In Appendix A of this paper,

[1] In Agenda Paper 5B for the March 2014 Interpretations Committee meeting, the staff provided a list of variations to common features in Appendix A of that paper.

we also reproduce the analysis of a different type of joint arrangement structure that was included in Agenda Paper 5B for the March 2014 Interpretations Committee meeting to help understand various types of joint arrangements.

Staff analysis

Main features of the joint arrangement

3. We consider a joint arrangement where the parties (Parties A and B) set up a separate vehicle (Entity C) to construct infrastructure. The infrastructure has a high level of bespoke specification by the customer.

4. As in the case of the aforementioned Agenda Paper 5B, we assume that when we consider the example 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. The analysis, therefore, will focus on how to assess ‘other facts and circumstances’ in IFRS 11 *Joint Arrangements* with regard to some key features of the joint arrangement The key features are as follows:

- (**Feature A**) Parties A and B bid together for a contract with a customer (a government) for construction of infrastructure that will be owned by the government from the inception of the construction. The conditions for the execution of the contract (ie price, quality, design, execution period etc.) are fixed during the bidding process between Parties A and B and the government; for reaching this agreement the government is taking in mind the position of Parties A and B as global contractors (financial soundness, technical experience etc.).
- (**Feature B**) After the arrangement has been set up, Parties A and B create Entity C for the exclusive and limited purpose to execute the project. The project is executed according to the terms and

conditions agreed by Parties A and B during the bidding process, as mentioned in Feature A.

- (**Feature C**) Entity C has a legal personality that confers separation between Parties A and B and Entity C. Entity C is created only to facilitate the execution of the contract in a practical way (for example, hiring employees or subcontractors, preparing tax returns etc.). Whether Entity C has or has not legal personality depend on the jurisdiction.

- (**Feature D**) Entity C signs the construction contract with "the government". Concurrently with signing the contract, and as a compulsory condition to sign the contract, Parties A and B jointly and severally assume a guarantee to the government for the completion of the construction by Entity C to the government. This guarantee is in respect of all the conditions set out in the contract and agreed previously between Parties A and B and the government during the bidding process. According to this guarantee, Parties A and B are described as 'primary obligors and not merely as sureties.' The government's objective is to make sure that even though the contract is signed by Entity C, Parties A and B's position is the same as if the contract had been signed directly by Parties A and B. For the purpose of understanding the impact of this guarantee in the current analysis two aspects of the guarantee are highlighted:

  (i) the obligations of Parties A and B are not subsidiary to the obligations of Entity C. The government is not obliged, before enforcing any of its rights or remedies under this guarantee, to commence proceedings or take any action against or in respect of Entity C; and

  (ii) if Entity C terminates or is unable to operate as an entity, Parties A and B continue having the same rights and obligations and so they would be required to sign an identical agreement to the initial one signed by Entity C.

- **(Feature E)** Parties A and B jointly and severally provide guarantees, in most cases, for the payment to suppliers or other creditors of Entity C. This guarantee is an extension of the main guarantee with the government (feature D), and the position of Parties A and B is also as primary obligors.
- (**Feature F**) Entity C has a minimal level of capital. According to the shareholders agreement, Parties A and B are contractually obliged to provide financing to Entity C through cash calls without limitation. A cash call is a commitment whereby Entity C can demand cash from Parties A and B in order to meet Entity C's cash flow needs. On the other hand, any cash surplus will be transferred to Parties A and B, who will have to return back that cash if it is needed by Entity C[2].
- (**Feature G**) The construction in progress belongs to the government. In effect, the joint arrangement is the provision of construction and civil engineering *services* to the government. Consequently, Entity C does not hold any construction in progress. Entity C's assets and liabilities[3] are primarily accounts receivable and amounts due from the government in respect of construction services delivered to the government, accounts payable to suppliers, cash received from the government (prepayment)[4] or from cash calls from Parties A and B, and non-financial liabilities in terms of the performance obligation.
- (**Feature H**) As Entity C has signed the contract, Entity C invoices the construction service directly to the government.

[2] In a normal situation, the transfer is automatically triggered by a contractual agreement. In other cases, Parties A and B will take a decision on a monthly or three-month basis, taking into account the expected short term cash flow of the contract.

[3] Assets such as plant and machinery used to perform the construction generally belong to Parties A and B, and are leased to Entity C.

[4] In a normal situation, cash received from the government (prepayment) is automatically transferred to Parties A and B by a contractual agreement.

Some joint arrangements will be established such that Entity C invoices Parties A and B and then they invoice the government, but this arrangement is less common.

- **(Feature I)** The roles of joint activities are, in some cases, split between Parties A and B (ie Party A is only involved with one part of the process and Party B is only involved with the other part of the process).

Overview of analysis

5. We first note that according to Feature C, Entity C has a legal form and signs the contract for providing output of the joint arrangement to the government. We also note that output generated by this joint arrangement would be a 'service' (ie the construction service) rather than 'goods' (ie the infrastructure to be constructed). This is because the infrastructure would be owned by the government from the inception of the project (**Feature A**) and Entity C does not recognise 'construction in progress' as an asset (**Feature G**). Accordingly, the assets and liabilities of Entity C would be mainly financial assets, financial liabilities and non-financial liabilities in terms of performance obligations.

6. On the basis of the observations above, we think that the overall scheme of this joint arrangement can be summarised as follows:

   (a) Parties A and B negotiate with the government, then establish Entity C;

   (b) afterwards, Entity C directly enters into a contract with the government for the supply of the construction service based on the terms agreed between Parties A and B and the government.

   (c) Concurrently with signing the contract and as a compulsory condition to sign the contract, Parties A and B jointly and severally assume a guarantee to the government for the completion of the construction by Entity C. We understand that this guarantee provides comfort to the government so that even though the contract is signed by Entity C, Parties A and B are in the same position as if the contract had been signed directly by Parties A and B.

7. In this scheme, we think that it is important to first identify whether Parties A and B are also 'contractually obliged' to provide the construction service to the government. If that is not the case, we would not be able to proceed with our examination about whether they have, in substance, rights to the assets and obligations for the liabilities of Entity C. This is because assessing 'other facts and circumstances' should focus on contractual and enforceable rights to the assets and obligations.

8. In this regard, we think that we can reject a possibility that Entity C provides the construction service to Parties A and B and then they provide it to the government; the case we reject is different from outsourcing the service through a subcontractor, which is to provide a service by a subcontract to a third party[5]. We think that when the output of the joint arrangement is a 'service', it would not be possible for the parties to re-sell that service to a third party. We therefore will only consider whether Parties A and B, jointly with Entity C, are contractually obliged to provide the construction service to the government.

9. Our examination therefore will consider whether:

[5] If we consider this example as outsourcing a service through subcontract, we can think of two cases in which (scenario 1) Entity C is a main contractor with a third party (ie the government) and Parties A and B are subcontractors; and (scenario 2) Parties A and B are main contractors with a third party and Entity C is a subcontractor.

We think that scenario 1 would be consistent with this example, but this fact would not reverse or modify the rights and obligations conferred by the legal form of the separate vehicle. We think that scenario 2 is not consistent with this example because Entity C enters into a contract with the government.

(a) Parties A and B, jointly with Entity C, are contractually obliged to provide the construction service to the government (**Analysis 1**); and

(b) if so, they have, in substance:

(i) rights to the assets of Entity C by having rights to substantially all the economic benefits of the (financial) assets of Entity C (**Analysis 2**); and

(ii) obligations for the liabilities of Entity C by being substantially the only source of cash flows that can ensure the settlement of the liabilities of Entity C on a continuous basis. (**Analysis 3**)

10. In addition, we will address a concern about different accounting depending on whether the joint arrangement has legal personality or non-legal personality. (**Analysis 4**)

Analysis 1: Are Parties A and B contractually obliged to provide the construction service to the government?

11. We note that according to Feature D (ie Parties A and B provide a performance guarantee for the completion of construction by Entity C to the government.), Parties A and B are described as 'primary obligors and not merely as sureties' under a performance guarantee contract between those parties and Entity C. We think that there could be two different interpretations of this description:

(a) (Case 1) Entity C still has a primary responsibility for providing the construction service to the government notwithstanding the description as noted above; or

(b) (Case 2) Parties A and B are in the same position as Entity C in terms of providing the construction service to the government. We note the importance attached to this guarantee by the government through this being a compulsory requirement of the agreement signed by Entity C.

12. We note that Case 1 would not indicate that Parties A and B provide the construction service to the government. Entity C provides the construction service and therefore has the rights to the financial assets of Entity C, which are recognised through the revenue from the government.

13. However, we think that Case 2 would indicate that Parties A and B are contractually obliged to provide the construction service to the government because they are in the same position as Entity C in providing the service to the government.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree that Feature D (ie Parties A and B provide a performance guarantee for the completion of construction by Entity C to the government.) can be interpreted in two ways (ie 'Case 1' and 'Case 2') as noted above?
2. If 'yes' to Question 1, does the Interpretations Committee agree that Case 2 would indicate that Parties A and B are contractually obliged to provide the construction service to the government?

Analysis 2: Parties A and B have, in substance, direct rights to the assets of Entity C?

14. We think that if Parties A and B are obliged to provide the construction service to the government as shown in Case 2 above, it may be argued that they have rights to the assets of Entity C because the (financial) assets of Entity C consists of those that are recognised for providing the construction service.

15. However, we note that if we follow that argument, Entity C also would have rights to those assets. This means that Entity C also have the economic benefits of those assets just as Parties A and B do. We think that unless Entity C is precluded from having the economic benefits of its assets, Parties A and B would not have 'substantially all' economic benefits of those assets; they would have only 'some' economic

benefits. And if Parties A and B do not have 'substantially all' economic benefits, they would not have, in substance, direct rights to the assets of Entity C. This is because paragraph B31 of IFRS 11 requires the parties to the joint arrangement to have 'substantially all' economic benefits of the assets of the joint arrangement so that they can have, in substance, direct rights to the assets of the joint arrangement. We therefore think that putting Parties A and B in the 'same' position as Entity C, as described in Case 2, cannot be interpreted to preclude Entity C from having the economic benefits of its assets and thus would not indicate that Parties A and B have, in substance, direct rights to the assets of Entity C.

16. Consequently, we think that **Feature D**, whether it is Case 1 or Case 2, would not indicate that Parties A and B have, in substance, direct rights to the assets of Entity C.

17. We also think that **Feature G** would not suggest that Parties A and B have, in substance, direct rights to the assets of Entity C. Particularly, we note the point in Feature G that Entity C records accounts receivable and amounts due from the governments in return for providing the construction service to the government. This means that cash collected from the government will reside in the books of Entity C. We think that if we can say that Parties A and B have, in substance, direct rights to the cash collected from the government that resides in the books of Entity C, they should be able to receive the 'gross' cash proceeds from Entity C. This is because we think that IFRS 11 requires the parties to have, or be considered to have, 'gross' rights to the assets and 'gross' obligations for the liabilities relating to the joint arrangement in order for the joint arrangement to be classified as a joint operation.

18. We think that the fact that Parties A and B reached an agreement with the government and Entity C was just created to execute the agreement as referred in Features A and B would not give the parties 'gross' rights and 'gross' obligations. We think that whether Parties A and B have 'gross' rights and 'gross' obligations depends on the cash flows of Entity C. We think that Parties A and B would have the 'net' amount

(ie the amount after deducting costs incurred in Entity C) of cash proceeds from Entity C, but not the ‘gross’ amount of cash proceeds from Entity C. In this regard, we note that according to Feature G, cash received from the government (prepayment) is automatically transferred to Parties A and B by a contractual agreement. This would indicate that Parties A and B would have the ‘gross’ amount of cash proceeds from Entity C. Nonetheless, we think that it would only show that Parties A and B have ‘some’ economic benefits of the assets in Entity C, but not ‘substantially all’ economic benefits of Entity C. This is because we think that such cash balance would constitute ‘some’ assets of Entity C, but not ‘substantially all’ assets of Entity C.

19. Consequently, we think that **Feature G** would also indicate that Parties A and B do not have, in substance, direct rights to the assets of Entity C.

20. In addition, we think that **Feature H** (ie Entity C invoices the construction service directly to the government or Parties A and B) would be consistent with our conclusion above drawn from Features D and G. Although we note that the fact that invoicing is done by Entity C in itself would not be a determinative feature, we think that it is consistent with the fact that the assets related to invoicing (ie financial assets) are only recorded in the financial statements of Entity C rather than Parties A and B[6]. We think that this would support that Parties A and B do not have, in substance, direct rights to the assets of Entity C.

Question for the Interpretations Committee
3. Does the Interpretations Committee agree with the staff analysis that Parties A and B would not have, in substance, direct rights to the assets of Entity C, based on Features D, G and H?

[6] If the joint operation sells its output to the joint operators, its financial assets (ie account receivables) from the sale would be eliminated against the financial liabilities (ie account payables) of the joint operators. Consequently, the issue of recording the assets related to invoicing would only arise when the output is sold to third parties.

Analysis 3: Parties A and B have, in substance, obligations for the liabilities of Entity C?

21. With regard to the financial liabilities of Entity C, we note that **Feature F** (ie Parties A and B provide financing to Entity C through cash calls) would indicate that Parties A and B have the obligation to potentially provide substantially all the cash flows for Entity C and could therefore be required to settle the financial liabilities of Entity C on a continuous basis. We reach this conclusion on the understanding that if cash calls mean that whenever Entity C needs cash for its normal operation, Parties A and B can be required to provide funds to Entity C. However, another fact described in **Feature F** that Entity C receives cash from the government (prepayment) might indicate that Parties A and B are not required to provide funds to Entity C. This is because if Entity C can receive sufficient prepayment from the government sufficiently enough to meet its cash needs, Parties A and B would not need to provide cash to Entity C for Entity C's normal operation.

22. We think that **Feature E** (ie Parties A and B's guarantee to the suppliers or creditors of Entity C) might indicate that Parties A and B are required to settle the financial liabilities of Entity C on a continuous basis. This is because Parties A and B are considered as 'primary obligors' under this guarantee. However, we think that the assessment could vary depending on the meaning of the term 'primary obligors' in specific guarantee agreements. If this term does not suggest that Parties A and B are required to settle the financial liabilities of Entity C on a continuous basis, Parties A and B would not have, in substance, obligations for the liabilities of Entity C.

Question for the Interpretations Committee
4. Does the Interpretations Committee agree with the staff analysis that the assessment of Feature E and F would involve more specific contractual requirements of individual transactions in order to conclude that Parties A and B have, in substance, direct obligations for the liabilities of Entity C?

Analysis 4: legal personality and non-legal personality

23. During our outreach that informed us about the fact pattern described in this paper, concerns were raised to us about a circumstance in which:

(a) when based on an assessment of 'other facts and circumstances', the parties to the joint arrangements have the same contractual arrangements whether or not the joint arrangement has legal personality; but

(b) different accounting is required depending on whether the joint arrangement has legal personality or non-legal personality.

24. This concern relates to Feature C (ie different legal status of the joint arrangement depending on the jurisdictions) and feature D (according to the guarantee the parties to the joint arrangement are in the same contractual position as the joint arrangement relating to the assets and liabilities of the joint arrangement).

25. The concern can be illustrated by an example. Suppose that:

(a) The same Parties A and B in the example above provide a construction service to two governments for building a bridge that links two countries through a joint arrangement. Parties A and B agree on the conditions for the execution of the construction with the governments during the bidding period.

(b) The joint arrangement is executed using two separate vehicles: Entity X in Country X and Entity Y in Country Y. Parties A and B have joint control over, and 50% of the shares of, both of these entities.

(c) According to national legislation, Entity X has non-legal personality and Entity Y has legal personality. The reason for this difference is because according to legislation in Country Y it is not possible to create non-legal entities. Consequently, the government requires such a guarantee as mentioned in Feature D to be sure that even though Entity Y has legal personality, Parties A and B's position is the same as if in the case of Entity X.

(d) The non-legal personality of Entity X leads directly to the parties classifying the joint arrangement (Entity X) as a joint operation.

(e) In the case of Entity Y, key features are those mentioned in the example of this paper.

26. In this setting, the question arises whether it could be appropriate that the same joint arrangement is classified differently as a joint venture in the case of Entity Y, taking into consideration that both Parties A and B have the same contractual arrangements for the case of Entity X and Entity Y. However, we think that it could be consistent with the requirements in IFRS 11 for the same joint arrangement to be classified differently as a joint venture in the case of Entity Y. This is because IFRS 11 states that the legal form of the separate vehicle affects the rights and obligations of the parties to the joint arrangement when assessing the type of joint arrangement. Paragraphs BC22 and BC43 of IFRS 11 state that:

> B22 The legal form of the separate vehicle is relevant when assessing the type of joint arrangement. The legal form assists in the initial assessment of the parties' rights to the assets and obligations for the liabilities held in the separate vehicle, such as whether the parties have interests in the assets held in the separate vehicle and whether they are liable for the liabilities held in the separate vehicle.
>
> 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.

27. We also note that the fact that Parties A and B have the same contractual arrangements for Entity X and Entity Y would not automatically lead to the same classification of the joint arrangement. In IFRS 11, if a joint arrangement is not structured through a separate vehicle, it is automatically classified as a joint operation, while an assessment is necessary for a joint arrangement which is structured through a separate vehicle. Accordingly, if the parties have the same contractual arrangements for a joint arrangement that is not structured through a separate vehicle and the other arrangement that is structured through a separate vehicle, the classification can be different.

28. In addition, we note that in this example, the classification of the joint arrangement would depend on the assessment of ‘other facts and circumstances’ even though the joint arrangement has a different legal status depending on jurisdictions. Accordingly, we think that there needs to be specific ‘other facts and circumstances’ present in Entity Y, which may or may not also be present in Entity X, in order to overcome the legal form of Entity C.

Question for the Interpretations Committee
5. Does the Interpretations Committee agree with the staff analysis that two

joint arrangements with very similar contractual arrangements can result in a different classification of the joint arrangement, depending on whether they are structured through a separate vehicle or not?

Summary and conclusion of staff analysis

29. We first examined whether Parties A and B are contractually obliged to provide the construction service to the government. We noted that if **Feature D** (ie Parties A and B provide performance guarantee for the completion of construction by Entity C to the government) implies that Parties A and B are in the same position as Entity C in terms of providing the construction service to the government, they would be contractually obliged to provide the service to the government. (**Analysis 1**)

30. However, we noted that Parties A and B alone would not have, in substance, direct rights to the assets of Entity C. This is because:

(a) Parties A and B are in the 'same' position as Entity C and therefore would not have 'substantially all' economic benefits of the assets of Entity C without considering Entity C; and

(b) considering that Entity C records accounts receivables and amounts due from the government in return for providing the construction service to the government (**Feature G**), we think that Parties A and B would receive not the 'gross' cash proceeds from Entity C, but the 'net' amount (ie the amount after deducting costs incurred in Entity C) and therefore would not have 'gross' rights to the assets of Entity C. (**Analysis 2**)

31. We also examined whether Parties A and B have, in substance, direct obligations for the liabilities of Entity C. We noted that:

(a) **Feature F** (ie Parties A and B provide financing to Entity C through cash calls) could indicate that Parties A and B have the obligation to potentially provide substantially all the cash flows for Entity C and could therefore be required to settle the financial liabilities of Entity C on a continuous basis;

(b) however, another fact in **Feature F** that Entity C receives cash from the government (prepayment) might indicate otherwise; and

(c) In addition, **Feature E** (ie Parties A and B's guarantee to the suppliers or creditors of Entity C) might indicate that Parties A and B are required to settle the financial liabilities of Entity C on a continuous basis. (**Analysis 3**)

32. In addition, we examined **Feature C** (ie different legal status of the joint arrangement depending on the jurisdictions). We noted that:

(a) it could be consistent with the requirements in IFRS 11 for the same joint arrangement to be classified differently by an entity having non-legal personality and an entity having legal personality;

(b) this is because IFRS 11 states that the legal form of the separate vehicle affects the rights and obligations of the parties to the joint arrangement when assessing the type of joint arrangement; and

(c) therefore, the classification of the joint arrangement would depend on the assessment of 'other facts and circumstances' even though the joint arrangement is considered to have a different legal status depending on jurisdictions. Consequently, we think that there needs to be specific 'other facts and circumstances' present in Entity Y in order for it to overcome the legal form of Entity C. (**Analysis 4**)

33. In conclusion, we note that:

(a) Parties A and B would not have, in substance, direct rights to the asset of Entity C even if the feature of 'performance guarantee' (**Feature D**: Parties A and B provide performance guarantee for the completion of construction by Entity C to the government) put Parties A and B in a position of being contractually obliged to provide the construction service to the government; and

(b) Parties A and B could have, in substance, direct obligations for the liabilities of Entity C because of the feature of 'cash calls' (**Feature F**: Parties A and B provide financing to Entity C through cash calls), whereas the fact that Entity C receives cash from the government (prepayment) might indicate otherwise.

34. Consequently, we think that a joint arrangement having the features in the example would not be classified as a joint operation. This is because in order to classify a joint arrangement as a joint operation, IFRS 11 requires that the parties to the joint arrangement have, in substance both direct rights to the assets and direct obligations for the liabilities, relating to the joint arrangement.

Staff recommendation

35. We note the concern that was raised about how two very similar scenarios can lead to different accounting depending on whether there is a separate legal entity involved or not. However, we think that this is reflective of the approach adopted in IFRS 11 and the importance that IFRS 11 places on:

(a) reflecting the rights and obligations of the parties to the joint arrangement; and

(b) the presence of a separate legal entity affecting those rights and obligations.

36. Consequently, we do not recommend that the Interpretations Committee take this issue to its agenda. We think that the assessment of the classification of a joint arrangement depends on specific contractual terms and conditions and requires a full analysis of features involving the joint arrangement. We also think that the requirements in IFRS 11 are consistent in providing the principles for the assessment of the

classification of a joint arrangement and therefore, additional guidance would not be necessary.

Questions for the Interpretations Committee
6. Does the Interpretations Committee agree with the staff analysis that: (a) the type of project entity arrangement identified in this paper would not be classified as a joint operation, when taking into account the features noted in this paper? 7. Does the Interpretations Committee agree with the staff recommendation not to take this issue to the agenda?

Appendix A—Reproduction of the analysis of a different common joint arrangement structure that was included in Agenda Paper 5B for the March 2014 Interpretations Committee meeting

IFRS™

Agenda ref 5B

STAFF PAPER

March 2014

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[7]. Particularly, we will address some joint arrangements that are structured in the form of so-called 'project entities'[8] in various industries and jurisdictions.

[7] 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.

[8] 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.

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 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)[9] which has the following project life-cycle:

    - Parties A and B find suitable land for construction and third party customers.

[9] 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.

- 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.
- Entity C[10] 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.

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

(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[11].

(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 is managed by Parties A and B's legal

[11] 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
- choose the contractors and manage the operations (commercialisation, administrative function).

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').

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: (b) 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)