STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IFRS 11 *Joint Arrangements***
Paper topic	Accounting within separate financial statements

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Introduction

1. As mentioned in Agenda paper 2, at its January 2014 meeting, the IFRS Interpretations Committee (the 'Interpretations Committee') requested the staff to provide an analysis to consider the implication for accounting within separate financial statements,[1] when examining the issue of how and why particular 'other facts and circumstances' create rights and obligations that result in the joint arrangement being classified as a joint operation.

2. In response to the request, we will address the accounting within separate financial statements when the joint arrangement is structured through a separate vehicle. In particular, we will deal with the issue of separate financial statements when the joint arrangement is classified as a joint operation. The issue is about how to prepare separate financial statements of a joint operation (ie separate vehicle).

[1] In this paper, separate financial statements means the separate financial statements that are compliant with the IFRS Standards.

Background

3. At its November 2013 meeting, the Interpretations Committee discussed the joint operator's accounting in its separate financial statements for an interest in a joint operation that is housed in a separate entity.[2] This was within the context of a consultation by the IASB to help the IASB assess the magnitude of accounting issues in the separate financial statements of the joint operator when the joint operation is housed in a separate vehicle.

4. The Interpretations Committee noted that:[3]

   (a) the issue is prevalent in practice because separate IFRS financial statements are common in many jurisdictions, and, in addition, joint arrangements structured through separate vehicles are more often classified as joint operations in practice than was originally expected.

   (b) it is clear and consistent that IFRS 11 *Joint Arrangements* requires the same accounting for joint operations in the consolidated IFRS financial statements and the separate IFRS financial statements, because it requires the joint operator to account for all of its rights and obligations.

   (c) in order to be classified as a joint operation, the parties to the joint arrangement must have sufficient rights to, and obligations for, the assets and liabilities held in the entity such that these rights and obligations pierce the veil of incorporation. In this case, IFRS 11 requires that the joint operator does not account for its shareholding in the entity that houses the joint operation at cost in accordance with IAS 27 *Separate Financial Statements* or at fair value in accordance with IFRS 9 *Financial Instruments*. Instead, the joint operator accounts for its rights and obligations, which are its shares in the assets held by the entity and its shares in the liabilities incurred by it.

[2] Refer to Agenda Papers 11 (http://www.ifrs.org/AP11) and 11A (http://www.ifrs.org/AP 11A) presented at the November 2013 Interpretations Committee meeting.

[3] Refer to IFRIC *Update* for November 2013 (http://media.ifrs.org/IFRIC Update).

(d) the classification of a joint arrangement as a joint operation depends on the rights and obligations that the parties have. Consequently, the assessment of those rights and obligations is critical to making this classification.

5. At its November 2013 meeting, the Interpretations Committee was also presented with a list of various implementations issues with regard to IFRS 11, which were collected from an outreach request.[4] The list included two issues relating to accounting within separate financial statements. The two issues[5] were summarised in the paper presented to the Interpretations Committee at its November 2013 meeting as follows:

(a) 'One respondent raised a concern about accounting in preparing separate financial statements of the joint operation. Specifically, the respondent asked how a joint operation contained in a separate legal vehicle should recognise, measure, and disclose its financial information, because all of its assets, liabilities, revenues, and expenses are included on the face of the financial statements of its investors.'

(b) 'One respondent raised a recognition issue about the accounting in preparing separate financial statements of the joint operator. The issue relates to a circumstance in which a joint operation has an investment in a subsidiary. Specifically, the respondent questioned whether a joint operator should recognise an additional share of assets if the joint operator finances the cost of the investment.[6]'

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[4] Refer to Agenda Paper 10 (http://www.ifrs.org/AP10) presented at the November 2013 Interpretations Committee meeting.

[5] The two issues were denoted as 'Additional Issue 16' and 'Additional Issue 17' respectively under Category E in Agenda paper 10 for the November 2013 Interpretations Committee meeting.

[6] The respondent provided the following example: a joint operation (Entity C) has an investment in subsidiary (Entity D) whose cost is CU20. The cost of the investment was financed with an additional CU20 of equity from the two joint operators (ie CU10 from each Entity A and B). Entity D sells all its output to Entity C. At the year end, Entity D has sold CU10 of output (not yet collected) and purchased CU7 of materials (not yet paid). The respondent questioned whether Entities A and B should additionally recognise its share of assets (CU10 plus CU5), liabilities (CU 3.5), revenues (CU5) and costs (CU 3.5) of the joint operation.

Staff analysis

6. As noted above, we will examine the issue of the accounting within the separate financial statements of a joint operation (ie the separate vehicle)).

7. We think that this issue can be addressed without re-deliberating on the conclusion that the Interpretations Committee reached at its November 2013 meeting, which is:

   (a) IFRS 11 requires the same accounting for joint operations in the consolidated financial statements and the separate financial statements;

   (b) the joint operator does not account for its shareholding in the entity that houses the joint operation at cost in accordance with IAS 27 or at fair value in accordance with IFRS 9; and

   (c) instead, the joint operator accounts for its rights and obligations, which are its shares in the assets held by the separate vehicle and its shares in the liabilities incurred by it.

8. This is because the conclusion relates to principles of the accounting within the separate financial statements of a **joint operator,** whereas this issue relates to the accounting within the separate financial statements of a **joint operation** (ie the separate vehicle).

9. Consequently, we will assess this issue on the basis of the conclusion at the November 2013 Interpretations Committee meeting.

Overview of the issue

10. IFRS 11 sets out requirements for the accounting for financial statements of parties to a joint arrangement but not for the accounting for financial statements of a joint arrangement (ie the separate vehicle). This would imply that IFRS 11 applies to the financial statements of the joint operator, but does not apply to the financial statements of the joint operation. Accordingly, if a joint arrangement is structured through a separate vehicle and the financial statements of that separate entity are prepared in accordance with IFRS, we

think that those financial statements would be prepared in accordance with relevant requirements in the other Standards.

11. We note that this issue raised only relates to financial statements of the separate vehicle when the joint arrangement is classified as a joint operation. We observe that the concern raised from the outreach activity relates to a concern about duplicate reporting of information. The concern raised is that the financial statements of a joint operation (ie the separate vehicle) would provide the same information as the financial statements of joint operators, because the joint operators, in their separate financial statements, would recognise all the assets, liabilities, revenues and expenses of the separate vehicle, because they have pierced the veil of incorporation of the separate vehicle. Consequently, the concern is that the same assets, liabilities, income and expense would appear in the financial statements of the joint operators and the financial statements of the joint operation.

12. We observe that a similar concern was recently raised by one of the national accounting standard setters when it pointed out three problems for the separate financial statements of the joint operator. One of these three problems is:[7]

> *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.

[7] The concern was identified in Agenda Paper 12 (http://www.ifrs.org/AP12) presented at the September 2013 IASB meeting and also in Agenda Paper 11A (http://www.ifrs.org/AP 11A) presented at the November 2013 Interpretations Committee meeting.

Separate financial statements of the joint operation based on legal form

13. We first note that the concern raised from the outreach is based on an argument that if the joint operators account for all the assets, liabilities, revenues and expenses of the separate vehicle, it would be at odds with the requirements of IFRS 11 to recognise those assets, liabilities, revenues and expenses in the financial statements of the separate vehicle. We think that the basis of such an argument is that the requirements of IFRS 11 for the accounting of the joint operators imply that the legal form of the separate vehicle is overridden and, therefore, the financial statements of the joint operators are prepared as if the separate vehicle did not exist.

14. We think that the accounting of the separate vehicle needs to be considered from the perspective of the separate vehicle. Accordingly, the legal form of the separate vehicle would ring-fence/circumscribe the assets, liabilities, income and expense from the perspective of the separate vehicle. In other words, we think that preparing the financial statements of the separate vehicle would mean that its legal form is respected. We think that it is similar to the preparation of financial statements of the branch of a company–the assets, liabilities, income and expense of those branch financial statements will also be included in the separate financial statements of the company itself, because the branch is part of the company[8].

Comparison between the separate financial statements of the joint operator and the joint operation

15. We think that the accounting within the separate financial statements of the joint operation (ie the separate vehicle) can be different from that of the joint operator depending on the type of assets and liabilities of the separate vehicle and the agreement between the joint operators and the separate vehicle.

[8] We note that IFRS Standards do not address the accounting of the financial statements of the branch of a company specifically. In this regard, we first note that IAS 21 *The effects of changes in Foreign Exchange Rates* describes a branch as an entity that is a part of a reporting entity along with subsidiary, associate and joint arrangement.

16. Take the example of the separate vehicle selling output to the parties to the joint arrangement, as described in Example 5 in IFRS 11. In that example, if the joint arrangement is classified as a joint operation, the asset that produces the output will be recognised in the separate financial statements of the joint operator. We note that from the perspective of the separate vehicle, selling output to the parties would be a commitment. In this sense, we think that such a commitment would be considered as an executory contract from the perspective of the separate vehicle and therefore would not be accounted for unless it is onerous. Consequently, we think that there would be no difference in accounting for the asset that is related to the output, between the separate financial statements of the joint operator and the joint operation; that is, the asset will be recognised without any adjustment in the separate financial statements of the joint operation.

17. On the other hand, we note that there may be some agreements between the joint operators and the separate vehicle that are not executory contracts. For example, there may be a finance lease agreement between the parties to the joint arrangement and the separate vehicle. We note that if the lease agreement indicates that the parties are considered to have rights to the assets of the separate vehicle and thus the joint arrangement is classified as a joint operation, the joint operator will account for the leased asset as its own asset. However, the separate vehicle will account for the leased asset in accordance with IAS 17 *Leases*. Consequently, we think there could be difference in accounting between the separate financial statements of the joint operator and the joint operation.

18. On the basis of the analysis above, we think that the information in the separate financial statements of the joint operation could be, but would not necessarily be, the same as that of the joint operator. Furthermore, we think that these two sets of the separate financial statements have different objectives and portray different reporting entities. Consequently, even if an item of financial statements is presented in the separate financial statements of both the joint operation and the joint operators, we think that it would be appropriate from a financial reporting perspective.

Outreach to some stakeholders

19. We however note the fact that one of the national accounting standard setters raised a concern about the possibility of double counting of income for tax purposes. At the same time, we note that we did not hear the same concern from the respondents on our outreach activity. On the basis of these observations, we are not certain about how wide-spread the concern raised by the national accounting standard setter is and also whether there are any other practical issues relating to the accounting of the separate vehicle.

20. Consequently, we undertook additional outreach to some stakeholders (ie a number of accounting firms). Specifically, we asked:

Q1. Have you encountered in practice the preparation of the financial statements of the joint operation in accordance with IFRS when the joint operation is housed in a separate vehicle, ie the financial statements of the separate vehicle? If yes, how common is it?

Q2. Have you observed the same concern as the 'double counting' as noted above[9]? Please describe what you have observed. If there hasn't been such 'double counting' why is this?

Q3. Have you observed any other practical concerns in relation to the accounting in the financial statements of the joint operation when the joint operation is housed in a separate vehicle?

21. We received five responses.

22. With regard to Question 1, three respondents said that the preparation of the financial statements of the joint operation is common; one of them stated that it is very common, particularly for cases in which the joint arrangement is classified as a joint operation as a result of the assessment of 'other facts and circumstances'. One respondent said that it is potentially wide-spread. One respondent said that it is not wide-spread.

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[9] We included a description of the concern from one of the national accounting standard setters in our outreach request before stating the questions.

23. With regard to Question 2, no respondent said that they had observed a concern about ‘double counting’ although three respondents acknowledged that some jurisdictions raised a concern of double counting for income taxes.

24. With regard to Question 3, one respondent commented that it is difficult to assess whether the requirements in IFRS 11 for separate financial statements make sense in the absence of a more comprehensive conceptual analysis of the basis of separate financial statements and how they should differ from consolidated financial statements.

Summary of the analysis

25. We note that accounting within the separate financial statements of the joint operation (ie the separate vehicle) need to be considered from the perspective of the separate vehicle. This means that the legal form of the separate vehicle would be respected.

26. We also note that the accounting within the separate financial statements of the joint operation would not necessarily the same as that of the joint operator. This is because it depends on the type of assets and liabilities and agreements between the joint operation and the joint operators. Furthermore, we think that these two sets of the separate financial statements have different objectives and portray different reporting entities. Consequently, the presentation of the same item in the separate financial statements of both the joint operation and the joint operators could be appropriate and would depend on the agreements between the joint operation and the joint operators.

27. In our outreach activity, we have not heard of any significant practical concern relating to the separate financial statements of the joint operation in terms of financial reporting perspective although we heard that there is a concern in terms of tax purposes.

Staff recommendation

28. On the basis of our analysis, we think that this issue does not cause practical concerns in terms of financial reporting perspective although we note that some jurisdictions raised a concern about accounting for income tax purpose. Consequently, we recommend that the Interpretations Committee do not take this issue onto its agenda.

Question for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff recommendation not to take this issue to the agenda?