

**Basis for Conclusions on
Exposure Draft**

ED 9 JOINT ARRANGEMENTS

Comments to be received by 11 January 2008

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paragraphs

**BASIS FOR CONCLUSIONS
ED 9 JOINT ARRANGEMENTS**

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Basis for Conclusions on ED 9 *Joint Arrangements*

This Basis for Conclusions accompanies, but is not part of, the draft FRS.

Introduction

- BC1 This Basis for Conclusions summarises the considerations in reaching the conclusions in ED 9 *Joint Arrangements*.
- BC2 ED 9 results from the IASB's Short-term Convergence project. The project is being conducted jointly by the IASB with the United States standard-setter, the Financial Accounting Standards Board (FASB). The project was added to the Board's agenda to reduce differences between IFRSs and US generally accepted accounting principles (GAAP) that are capable of resolution in a relatively short time and can be addressed outside of major projects.
- BC3 This part of the Short-term Convergence project relating to joint arrangements was undertaken by the IASB. The proposals were not deliberated by the FASB. The objective of the project is to improve financial reporting for those activities within the scope of FRS 31 *Interests in Joint Ventures*. The proposals in the exposure draft are concerned principally with remedying two aspects of FRS 31 that was considered an impediment to high quality reporting of joint arrangements—namely, that the form of the arrangement is the primary determinant of the accounting and that an entity has a choice of accounting treatment for interests in jointly controlled entities.
- BC4 Not all of the requirements in IAS 31 had been reconsidered. For example, it did not reconsider the equity method, nor did it reconsider the scope exclusion for venture capital organisations, mutual funds, unit trusts and similar entities. Accordingly, this Basis for Conclusions does not discuss requirements of FRS 31 that was not reconsidered. When the Basis for Conclusions on the FRS arising from this exposure draft was developed, it was intended to include relevant paragraphs from the Basis for Conclusions on FRS 31.

The problems with FRS 31

- BC5 The two main concerns that were addressed in the exposure draft are to change from treating the form of the arrangement as the most significant factor in determining the accounting, and to eliminate the choice of accounting that FRS 31 offers.
- BC6 Accounting for interests in joint arrangements in accordance with FRS 31 follows the form of an arrangement (ie the accounting can differ depending on whether a legal entity is established). It was acknowledged that the form of an arrangement affects the rights and responsibilities of an entity. For example, an entity might transfer an asset that it owns into an entity that it controls with the effect that the owner has limited its liability in relation to that asset by using a legal structure. Equally, however, an owner could reverse the effects of that legal structure through guarantees or indemnities.
- BC7 FRS 31 permits a choice of using the equity method or proportionate consolidation to account for interests in jointly controlled entities. It has been indicated that it will exclude options of accounting treatment from accounting standards when possible. Such options can lead to similar transactions being accounted for in different ways and, therefore, impair comparability.

The problem

- BC8 The accounting requirements of FRS 31 can lead to the recognition of assets that are not controlled and liabilities that are not obligations. When a party to an arrangement has joint control of an entity, it shares control of the activities of the entity. It does not, however, control each asset nor does it have a present obligation for each liability of the jointly

controlled entity. Rather, each party has control over its investment in the entity. If the party uses proportionate consolidation to account for its interest in a jointly controlled entity, it recognises as assets and liabilities a proportion of items that it does not control or for which it has no obligation. These supposed assets and liabilities do not meet the definition of assets and liabilities in the *Framework*. The *Framework* (paragraph 49) defines an asset as 'a resource controlled by the entity ...' and a liability as 'a present obligation of the entity ...'. Consequently, the amounts recognised are not a faithful representation of the entity's assets and liabilities.

- BC9 It was concluded that proportionate consolidation is not an appropriate method of accounting for jointly controlled entities. Recognising a proportionate share of each asset and liability of an entity is not consistent with the *Framework*, which defines assets in terms of exclusive control and liabilities in terms of present obligations. It leads to the recognition of amounts that do not represent faithfully an entity's assets and liabilities. For example, it could lead to a venturer recognising cash balances that it does not have the ability to direct or deploy, and from which it cannot obtain benefit, without consultation with other parties. Proportionate consolidation might generate information similar to recognising contractual rights and obligations, but that is by coincidence rather than by design.
- BC10 In addition, FRS 31 can lead to an entity not recognising its assets and liabilities. When a jointly controlled entity is similar in substance to jointly controlled operations or jointly controlled assets, a party controls assets and has obligations relating to the activities of the joint arrangement. These assets and liabilities should be recognised in the party's financial statements. However, if the party accounts for such jointly controlled entities using the equity method (because FRS 31 emphasises the form of the arrangement), the party does not recognise the assets that it controls and its liabilities.
- BC11 Therefore, it was also concluded that recognising a net interest in a joint arrangement (for example, when using the equity method) is not appropriate when the parties have contractual rights and obligations relating to individual assets and liabilities of the joint arrangement.
- BC12 Some argue that proportionate consolidation is a practical way to present a venturer's interest in a joint venture, particularly when the activities of the venture are an integral part of the venturer's operations. Despite its conceptual flaws, their view is that proportionate consolidation better meets the information needs of users of financial statements by providing a better representation of the performance of an entity's management and an improved basis for predicting future cash flows. It was noted these arguments but concluded that the practical argument does not refute the fundamental inconsistency with the *Framework*. It was believed that it is misleading for users of financial statements if an entity recognises as assets items that are not controlled, and as liabilities items that are not present obligations, and presents these together with items that it controls or items that are present obligations.
- BC13 It was viewed that the enhanced disclosure requirements of the proposed FRS would provide better information about the assets and liabilities of a joint venture than is provided by using proportionate consolidation. An entity presents, in its statement of financial position, a proportion of each asset and liability of jointly controlled entities when using proportionate consolidation. However, it is not possible to distinguish which assets the entity controls from those that the entity has the ability to direct and deploy only on agreement by other parties. The exposure draft proposes the disclosure of summarised financial information for all individually material joint ventures to help meet the needs of users of financial statements.
- BC14 It was also considered the views of some who point out that joint control and significant influence are different. They argue that it is inappropriate to account for an associate and a joint venture in the same way, using the equity method. Although it was acknowledged that significant influence and joint control are different, the equity method has been used to account for joint ventures in jurisdictions around the world for many years. The consideration of the equity method, and any alternative to it, is outside the scope of this short-term project.

The proposals

- BC15 It was therefore proposed to eliminate proportionate consolidation. It was proposed that a party to a joint arrangement should recognise its contractual rights and obligations arising from the arrangement. In meeting this principle, the descriptors of joint arrangements in FRS 31 require change so that the focus of the FRS is not on the form of an arrangement.
- BC16 It was proposed to use 'joint arrangement', rather than 'joint venture', to describe joint activities subject to the requirements of the FRS. It was also proposed that 'jointly controlled operations' and 'jointly controlled assets' should be described as 'joint operations' and 'joint assets'. The exposure draft retains 'joint venture' to describe joint arrangements that are subject to joint control and in which the parties have an interest only in a share of the outcome of the economic activities.
- BC17 The proposed definition of a joint arrangement requires shared decision-making by all of the parties to the arrangement, rather than joint control. This change was proposed because control is defined in FRS 27 *Consolidated and Separate Financial Statements* in the context of having power over financial and operating policies of an entity. This definition of control does not translate well to an asset or operation. Joint control is retained for a joint venture. It is an appropriate description of arrangements in which there is a separate business or economic activity over which the parties to the arrangement share the power to govern the financial and operating policies of the arrangement. Venturers do not often establish financial and operating policies for a joint operation or joint asset arrangement.
- BC18 The definition of an asset in the *Framework* requires an entity to control it—'an asset is a resource controlled by an entity' (paragraph 49). Therefore, an entity can recognise only assets that it controls. If an entity shares an asset, it recognises only those rights to the asset that it controls. Similarly, if an entity shares an obligation, it recognises only that portion of the obligation that it currently has.

The loss of joint control

- BC19 If an investor loses joint control but retains significant influence, the proposals mean that the investor accounts for its investment using the equity method both before and after the loss of joint control. It was proposed, for practical reasons, that in such circumstances an investor should not measure at fair value the investment it retains on the loss of joint control. This proposal would be readdressed at such time as it reconsiders the use of the equity method.

INT FRS 13 incorporated into the draft FRS

- BC20 There is a policy of incorporating into an FRS the consensus of any interpretation that is capable of incorporation within a single standard. Guidance on a topic is easier to find and use if it is located in one pronouncement. In accordance with this policy, it was proposed to incorporate into the FRS the consensus of INT FRS 13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers*.
- BC21 The consensus of INT FRS 13 regarding non-monetary contributions made by a venturer to a joint venture is consistent with the requirements in paragraph 22 of FRS 28 *Investments in Associates* regarding upstream and downstream transactions with associates. The consensus of INT FRS 13 has been incorporated by referring to the requirements of FRS 28.

Disclosure

- BC22 It was understood that users of financial statements would find it useful to have information about the nature and extent of an entity's operations conducted through joint arrangements. It was, therefore, proposed to require an entity to disclose such information.
- BC23 It was also proposed to align the disclosures required by the FRS regarding interests in joint ventures with the disclosure requirements in FRS 28 for investments in associates. Both associates and joint ventures are investments that an entity does not control but for which it has the power to influence strategic decisions. Both are recognised using the equity method

and the additional disclosures proposed relate mainly to the application of the equity method. It was viewed, therefore, is that the disclosure requirements of interests in joint ventures should be aligned with those required by FRS 28 for investments in associates in order to meet the needs of users of financial statements.

Assessment of net benefits

BC24 The proposals are intended to benefit financial reporting in three ways. First, an entity would be required to recognise only those assets that it controls and only those liabilities that are present obligations. Second, the removal of an optional accounting treatment would improve comparability. Third, the proposals would achieve convergence in principle with US GAAP, which generally requires the use of the equity method to account for jointly controlled entities. It was believed that these benefits would exceed any costs of implementation.