

Draft Illustrative Examples
JOINT ARRANGEMENTS

Comments to be received by 11 January 2008

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paragraphs

JOINT ARRANGEMENTS

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[DRAFT] Illustrative Examples

FRS X Joint Arrangements

This [draft] guidance accompanies, but is not part of, [draft] FRS X.

Introduction

- IE1 A party determines the type of joint arrangement on the basis of its rights and obligations that arise from the contractual arrangement. A joint operation or joint asset arrangement involves a party having contractual rights and obligations for individual assets and liabilities. A joint venture involves the parties having rights to a share of the outcome generated by the economic activities of the venture (paragraph 5).
- IE2 Examples 1–6 illustrate the application of the requirements of the [draft] FRS to arrangements in which parties have interests in joint operations, joint assets and joint ventures. Example 7 provides illustrative disclosures of joint arrangements.

Example 1– Joint construction operations

- IE3 Companies A and B form a company, C, to tender for a public contract with a government to construct a motorway between two cities. A and B have joint control of the activities of C.
- IE4 A will construct three bridges needed to cross rivers on the route; B will construct all of the other elements of the motorway. A and B will each use their own equipment and employees in the construction activity.
- IE5 C enters into a contract with the government for delivery of the motorway. It also enters into a contract with A and B for performance of the government contract. A and B will invoice C for their respective shares of the total amount invoiced by C to the government.

Analysis

- IE6 The arrangement is a joint operation, formed to facilitate bidding for a contract that the parties could not bid for individually. A and B have retained control of the assets they use to perform the contract requirements and are responsible for their respective liabilities. They meet their respective contractual obligations by providing services to C.
- IE7 A and B recognise in their financial statements their own property, plant and equipment and operating assets and their share of any liabilities resulting from the joint arrangement (such as performance guarantees). They also recognise the income and expenses associated with providing construction services to C.
- IE8 A and B also have an interest in C, which is recognised using the equity method. It is likely that their interests in C would be close to zero because C does not have any activities other than the contract with the government and the service agreements with A and B.

Example 2 – Joint interest in a jet aircraft

- IE9 Five advertising companies (the parties) jointly buy a jet aircraft. They enter into an agreement whereby each party has the right to use the aircraft for its own purposes some days each year. The parties may decide to use that right, or, for example, lease it to a third party. The parties share decision-making regarding maintenance and disposal of the aircraft. The decisions require the agreement of all of the parties.
- IE10 Each party is able to sell its interest to a third party, with the approval of the other parties. The agreement covers the expected life of the aircraft and can be changed only if all of the parties agree.

Analysis

- IE11 The arrangement involves a joint asset. The joint arrangement is a way to share the costs of having access to an aircraft. Each party has a unilateral right to use the jet aircraft for its own purposes some days each year, and would also have rights to its share of any residual value of the aircraft. It is those rights that the parties control and would recognise in accordance with applicable FRSs.

Variation – the asset is transferred to an entity

- IE12 Continuing the example, suppose the parties set up a company to purchase the jet aircraft. They continue to have an operating agreement that gives them the same rights to the aircraft as in the original example, ie the same rights of use. The operating agreement also includes the same disposal powers as in the original example.
- IE13 The aircraft is purchased in the name of the company, financed by cash contributions made by the parties. Any strategic operating and financing decisions made by the company require the agreement of all shareholders.
- IE14 A party can sell its interest in the aircraft by selling its shares in the company. The same restrictions on sale exist as in the original example (ie that all of the parties must approve the sale). Any new shareholder becomes a party to the operating agreement.

Analysis

- IE15 The modification to the example should have little effect on the accounting by the five advertising companies. The operating agreement ensures that the parties each have the same rights of use as in the original example. Each party would recognise its rights to the jet aircraft.
- IE16 What is different is that the parties also have an interest in the company. The company has legal ownership of the aircraft, and rights to the residual value of the aircraft. However, the rights of use have been transferred to the parties. The company structure might affect the responsibilities of the parties, by providing a liability shield. Each party would recognise its interest in the company using the equity method (ie the company is a joint venture). The aircraft asset recognised by the company will have been affected by the contractual allocation of rights of use to the parties. In other words, the company would recognise an aircraft asset that excludes the rights of use transferred to the parties. The result should be that there is no double-counting of the aircraft.

Example 3 – Jointly held office building

- IE17 Three companies (the venturers) jointly buy a 15-floor office building. Each floor in the building has a separate legal title, which allows a floor to be sold separately. Each venturer takes title (ownership) of five of the floors, one of which it uses for its own purposes. Each has a right to use that one floor for whatever purpose it chooses.
- IE18 The venturers set up a company and each transfers its ownership of four floors of the building to the company. The 12 floors are rented to third parties. The company employs a management team to manage the rental business.
- IE19 The company is controlled jointly by the venturers. The venturers are not liable for any costs of the company.

Analysis

- IE20 The venturers each have a direct interest in one floor and an interest in the company.
- IE21 The company is a joint venture. It operates as a separate business. The venturers have an interest in the profit generated by the operations of the company. They do not have a present obligation for costs nor do they have rights to the individual assets of the venture. They each have exchanged their rights to four floors of the building for an interest in the company.
- IE22 Each partner recognises its interest in one floor. Each also recognises its investment in the joint venture, using the equity method.
- IE23 The joint venture itself (the company) would recognise all of the remaining assets and liabilities of the joint arrangement, including the building (12 floors), furniture, rent receivables, and operating liabilities.

First variation – right of use through a lease

- IE24 Suppose that the venturers set up the company to purchase all 15 floors. Financing for the acquisition of the building is arranged in the name of the company, secured by the building.
- IE25 Each venturer leases one floor from the company. Each has the right to use that floor for its own purposes or to sublease it independently to third parties. The lease term is for all of the expected useful life of the building.
- IE26 The company rents the remaining 12 floors to third parties and employs a management team as detailed in paragraph IE18. The venturers jointly control the company.

Analysis

- IE27 The venturers each have a direct interest in one floor and an interest in the company (an interest in a joint venture).
- IE28 The change in the fact pattern (the venturers owned the three floors in the original example, whereas the company owns the three floors in this variation) does not change

the venturers' rights to use or sublease those three floors. In both situations, the venturers have a contractual right to use or sublease one floor.

- IE29 Each venturer recognises its interest in one floor in accordance with applicable FRSs, ie FRS 17 *Leases*.
- IE30 The venturers also recognise their interest in the company using the equity method.

Second variation – only one venturer has use of some floors

- IE31 Suppose that rather than all three venturers each having a right to use a floor, only one of them, company B, has that right (either through direct ownership or by way of a lease). Company B has use of three of the floors for its own purposes, and the remaining 12 floors are rented to third parties by the company set up by the venturers.

Analysis

- IE32 The change in the fact pattern does not change the nature of the joint arrangement, but the interests of the individual venturers are affected. In this case company B has an interest in three floors of the building that it recognises in accordance with applicable FRSs. Company B also recognises its investment in the joint venture using the equity method.
- IE33 The other two venturers recognise their interest in the company using the equity method.

Example 4 – Jointly owned shopping centre

- IE34 Two real estate companies (the parties) jointly buy the land and buildings that constitute a shopping centre. The parties have separately financed their share of the shopping centre acquisition.
- IE35 They set up a limited partnership for the purpose of operating the shopping centre business and transfer their ownership of the shopping centre to the partnership. The activities of the shopping centre business include renting the retail units, managing the car park, maintaining the centre and equipment such as lifts, and building the reputations and customer numbers for the centre as a whole. Strategic decisions relating to the operations require the consent of both parties.
- IE36 The terms of the limited partnership are such that each party receives a share of the income from the shopping centre (which is the rental income net of the operating costs). The parties have the right to sell or pledge their interest in the partnership.

Analysis

- IE37 The partnership is a joint venture. The parties have given up their interest in the shopping centre and exchanged it for an interest in the partnership. The partnership operates as a separate business, generating profit from the shopping centre. The parties cannot sell, pledge or otherwise access directly their share of the shopping centre. They do not have contractual rights to the shopping centre, but have an interest in the partnership.
- IE38 The parties recognise their interest in the partnership using the equity method.

Example 5 – Mining unitisation arrangement

- IE39 Four entities (the parties) each have rights to extract minerals from adjacent areas. The entities have financed their respective acquisitions. The parties enter into a contract to explore, develop and extract minerals from the combined area (the field). Each entity retains its legal ownership of the extractive rights for its defined area.
- IE40 The contract is for the economic extraction life of the defined area. The participation percentage of each party is based on the mineral reserves expected to be extracted from that party's acreage held and contributed to the geological area. The respective participation percentages are subsequently adjusted on the basis of the findings of an independent survey of the reserves. The parties receive output from the joint arrangement in the form of minerals that each can then hold, use or sell at its own discretion.
- IE41 One party has been designated as the operator. The parties establish a five-year strategic plan, which is updated annually on approval of all of the parties. The operator acquires equipment and allocates employees to the joint activities according to the strategic plan. The operator invoices the other parties for their share of expenses and capital expenditure based on their respective participations. The terms of the arrangement are such that each party is contractually responsible for a share of all costs and therefore each party has rights to a share of any assets purchased for the joint activities. Parties have joint and several liability for obligations such as decommissioning and environmental clean-up.

Analysis

- IE42 The joint arrangement involves joint assets. It is set up for the purposes of sharing costs. The arrangement is an extension of each party's operating activities to produce and sell minerals. The exploration activity represents a major input to the parties' businesses but is not itself a business.
- IE43 The parties retain their right to the economic benefits generated from the mineral rights—the benefits (usually received in the form of minerals) are directly related to the amount of mineral reserves contributed by each party to the arrangement. The parties have joint and several liability for obligations such as decommissioning, and also have obligations to reimburse their share of the costs incurred by the operator.
- IE44 Each party has rights to its share of the joint production equipment and other resources by directing the use of the equipment for the extraction of minerals. That share of the equipment and resources is equivalent to each party's mineral rights as a proportion of the total mineral rights of the field. Put another way, each party receives benefits from the assets in proportion to that party's mineral rights relative to the mineral rights of the combined field.
- IE45 The parties recognise as assets and liabilities their respective interests in the mineral rights, production equipment, minerals extracted, liabilities incurred, decommissioning liabilities and financing of the operations. The operator recognises receivables from the other parties (representing the other parties' share of expenses and capital expenditure borne by the operator). The non-operator parties recognise payables to the operator.

First variation – the parties share costs and risks

- IE46 Suppose that rather than the participation percentage of each party being based on the mineral reserves expected to be extracted from that party's acreage held, all parties

participate equally in the costs of and benefits obtained by the arrangement (ie the participation percentages of the parties are not adjusted). The parties agree to share equally the risks that one of the areas contributed to the arrangement does not have economically viable reserves.

Analysis

- IE47 The joint arrangement involves joint assets. The change in the fact pattern (the parties share costs and risks) does not change the type of arrangement. However, the joint asset in which the parties have an interest has changed. Each party has exchanged its mineral rights in one area for a percentage of the mineral rights in the combined area (the field). This exchange of assets does not mean that each party does not have an interest in a joint asset. Rather, each party has given up its sole right to minerals found in one area in exchange for a right to a share of minerals found in the field.
- IE48 The parties' contractual rights to the joint production equipment and contractual obligations are similar to those in the main example in paragraphs IE39–IE45. Each party is directly responsible for its share of the operating costs, including decommissioning and environmental obligations. Each party has rights to a share of the benefits obtained from the production equipment equal to its percentage interest in the mineral rights of the field.

Second variation – the parties share costs and risks and outsource the exploration activities to a company

- IE49 Continuing the first variation, suppose that the parties decide to set up a company to carry on the exploration, development and extraction activities. They become shareholders in the company; their percentage shareholdings are equal to their percentage interest in the combined field. As shareholders, they each have a seat on the board that determines the operating and financing policies of the company.
- IE50 The parties retain their ownership interest in the mineral rights. The company purchases the production equipment and employs a team to operate that equipment to explore and extract minerals from the field. On an ongoing basis, the company invoices the parties for their share of the exploration, development and extraction costs.
- IE51 The parties each have rights to receive their share of any minerals extracted from the field.

Analysis

- IE52 The parties have an interest in a joint asset (the mineral rights in the field) and an interest in a joint venture (the company).
- IE53 The change in the fact pattern means that the parties have outsourced the exploration and extraction activities to a company that they own and control jointly. The parties' rights and obligations have changed. The parties no longer have a direct interest in the production assets used in the activities, nor are they directly obliged to pay for costs of the company.
- IE54 The parties recognise the exploration costs invoiced by the company (these costs might be capitalised by the parties in accordance with FRS 106 *Exploration for and Evaluation of Mineral Resources*). They also recognise their interest in the company using the equity

method. The parties retain their rights to extract minerals from the combined field, and each party recognises its percentage share of the mineral rights of the field. The parties own and recognise as an asset the minerals extracted from the field.

Example 6 – Oil and gas ‘farm-in’ arrangement

IE55 An oil and gas company (B) has rights to carry on exploration activities in one field, and digs two exploration wells. The company enters into an agreement with two other oil and gas companies (C and D) to share the costs and risks associated with the exploration activities. C and D each contribute CU2 million and in return receive a 25 per cent working interest in the exploration field. All future costs of the exploration activities are shared 50:25:25 by the three parties to the arrangement, with B being contractually responsible for 50 per cent of the total costs. B is appointed as the operator. It purchases equipment, recruits employees and manages the exploration activities in accordance with the agreement, approved annually by the three parties.

Analysis

IE56 The arrangement involves joint assets. It is a cost-sharing and risk-sharing arrangement whereby B sells an interest in exploration assets and C and D buy an interest in exploration assets.

IE57 As in example 5, the parties are contractually obliged to pay for their share of the operating costs. They have contractual rights to a percentage of the exploration field including the exploration equipment that is constructed on the field.

IE58 C and D recognise their interest in the exploration assets and operating costs, and any financing of the operations. C and D would also recognise payables to B for their share of costs incurred and not yet paid.

IE59 At the time of the agreement, B recognises a gain or loss on disposal of exploration assets in accordance with applicable FRSs. Thereafter, B recognises its ongoing 50 per cent interest in the assets and operating costs. B also recognises receivables from C and D for their share of costs incurred and not yet reimbursed.

Variation – exploration, development and extraction

IE60 Continuing the example, suppose that in addition to exploration, the arrangement also relates to development and extraction of any oil and gas found in the field. The terms of the agreement are similar to those noted above—the parties receive a 50:25:25 interest in the exploration assets and also a proportionate share of any oil and gas extracted from the field. The parties are also responsible for their share of all costs.

Analysis

IE61 The arrangement involves joint assets. The change in fact pattern (by extending the arrangement to include development and extraction) does not change the nature of the interests that the parties have in the assets and liabilities of the arrangement (although the assets and liabilities themselves may change as the operations move to the development and extraction phase).

Example 7 – Illustrative disclosures of joint arrangements

Joint arrangements—joint operations and joint ventures

- IE62 Construct plc (the Company) participates in joint operation and joint venture arrangements. The Company has several construction joint operations. The largest of those is a joint operation with Build plc for the construction of the Olympic underground line in London, including three new underground stations. The Company is responsible for the construction of the stations. The arrangement commenced in March 2007, and is due for completion in 2011. The arrangement is expected to generate revenue of CU220 million for the Company in the period to 2011. [paragraph 36 of FRS X]
- IE63 The Company also has a joint venture, Bridge Limited, with two other parties, in which it has a 33 per cent interest. Bridge Limited's main activity is the construction of bridges spanning motorways. [paragraph 36] The Company has advanced funds of CU5 million to Bridge Limited which, according to a bank covenant, will be repaid to the Company after settlement of all other obligations of Bridge Limited. [paragraph 39(d)] The Company has agreed to advance a further CU2 million to Bridge Limited over the next two years. [paragraph 37(a)]
- IE64 The assets and liabilities of Bridge Limited are as follows.

	CU'000		CU'000
Non-current assets	30,000	Revenue	8,000
Current assets	6,000	Profit	2,700
Total assets	<u>36,000</u>		
Non-current liabilities	24,500		
Current liabilities	5,500		
Total liabilities	<u>30,000</u>		
Equity	<u>6,000</u>		

The Company's net interest in the joint venture is CU2,000. The Company's share of profit is CU900. [paragraph 39(b)]

Joint arrangements—joint assets

- IE65 Drill Co (the Company) conducts all of its exploration activities through joint asset arrangements. Two of those arrangements are significant. The first is an arrangement with X Co and Y Co to explore and develop oil and gas fields in Kicking Horse Canyon, an area of 30,000 acres east of Hot Springs. Exploration work began in 2007. [paragraph 36] The Company will provide funding of CU4 million to the joint asset arrangement over the next five years. [paragraph 37(a)]
- IE66 The second arrangement with Z Co is to explore and develop a gas field in Propane Valley. The Company acts as the operator. Two wells drilled during the year identified gas reserves in the field. [paragraph 36] The Company has agreed to drill a further four wells over the next two years at a cost of CU6 million. [paragraph 37(a)]

APPENDIX

Amendments to guidance on other FRSs

The following [draft] amendments to guidance on other FRSs are necessary in order to ensure consistency with [draft] FRS X. In the amended paragraphs, new text is underlined and deleted text is struck through.

- IGA1 In guidance on implementing Financial Reporting Standards (including Financial Reporting Standards and Interpretations), the following references are amended as described below
- 'FRS 31 *Interests in Joint Ventures*' is amended to 'FRS X *Joint Arrangements*'.
 - 'FRS 31' is amended to 'FRS X'.
- IGA2 In the Guidance on Implementing FRS 27 *Consolidated and Separate Financial Statements*, FRS 28 *Investments in Associates* and [FRS X *Joint Arrangements*], paragraphs IG2 and IG7 are amended as follows.
- IG2 Paragraph 4 of FRS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Paragraph 2 of FRS 28 defines significant influence as the power to participate in the financial and operating policy decisions of the investee but not to control those policies. ~~Paragraph 3 of FRS 31~~ Appendix A of FRS X defines joint control as the contractually agreed sharing of ~~control over an economic activity~~ the power to govern the financial and operating policies of a venture so as to obtain benefits from its activities. ...
- IG7 FRS 39 *Financial Instruments: Recognition and Measurement* does not apply to interests in subsidiaries, associates and ~~jointly controlled entities~~ joint ventures that are consolidated, or accounted for using the equity method ~~or proportionately consolidated~~ in accordance with FRS 27, FRS 28 and ~~FRS 31~~ FRS X respectively.

Table of Concordance

This table shows how the contents of FRS 31 and the draft illustrative examples correspond. Paragraphs are treated as corresponding if they address similar matters even though the guidance may differ.

FRS 31 paragraph	Draft IE paragraph
1	2
2	23
3	Appendix A
4	None
5	Appendix A
6	24
7	3
8, 9	None
10	7
11, 12	None
13	8
14	10
15	21
16,17	None
18	11
19,20	None
21	22
22, 23	None

FRS 31 paragraph	Draft IE paragraph
24	None
25	15,17
26	19
27, 28	None
29	20
30–37	None
38	23
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40	None
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44	None
45	29, 30
45A	31
45B	32
46	35
47	None

FRS 31 paragraph	Draft IE paragraph
48–50	27
51	29
52, 53	None
54	38
55	37
56	39(a),(b)
57	None
58	42
59	43, 44
None	1
None	4–6
None	9
None	12–14
None	16,18
None	26
None	36
None	39(c)–(e)
None	40, 41