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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**17 April 2008, London**
Project:	**Joint Arrangements**
Subject:	**Staff analysis of comment letters: Summarised overview (Agenda paper 10A)**

PURPOSE OF THE AGENDA PAPERS PRESENTED

1. The purpose of this agenda paper is to present an overview of the analysis of the comment letters received on ED 9 *Joint Arrangements*. More detailed information on the main comments received from respondents is found in Agenda Paper 10B. Agenda Paper 10C presents tables and graphs about the respondents to ED 9.

INTRODUCTION

2. ED 9 was issued in September 2007. The comment period ended on 11 January 2008. We received 111 comment letters. A complete list of the comment letters, detailing respondents' name, classification, industry, country and geographic area is included in Table 1 of Agenda Paper 10C.

3. The majority of comments received on ED 9 are from preparers and representative bodies of preparers, followed by professional bodies and standard-setters. Over 80% of the respondents fall within these four categories.

4. Most of the comment letters received were from respondents based in Europe with much lower representation from Asia-Pacific and North America. The industries with the largest representation were accounting (due to the comment letters received from professional bodies and standard-setters), followed by the energy and banking sectors.

5. We identified only two respondents we classify as 'users' or 'representative bodies of users'. This is a concern to staff and the paper identifies steps we expect to take to get more input from users—see *Conclusions and main suggestions from the staff* (paragraphs 50 - 51 of this paper).

GENERAL COMMENTS FROM RESPONDENTS

6. Approximately one third of the respondents expressed general support for the proposals. These respondents did not generally provide substantial explanations for their support and, if any were volunteered, they were consistent with the arguments provided in the exposure draft.

7. The remainder of the respondents disagreed with different aspects of the exposure draft. The sections 'main concerns' and 'other concerns' of this paper (paragraphs 13 - 40) discusses those areas of disagreement.

Project objectives

8. The two main objectives of the proposed standard are to enhance the faithful representation of joint arrangements by preventing the form of an arrangement being the most significant factor in determining the accounting and, in doing so, reduce divergence between IFRS and US GAAP. There was broad support for these objectives. There was less agreement, however, with how the exposure draft proposed achieving the objectives.

9. A majority of respondents expressed doubts about whether the proposals would bring an improved and comprehensive solution for the accounting of joint arrangements. Most of these respondents were from the banking, energy, food and beverage, chemicals and pharmaceuticals, industrial engineering, real estate industries and accounting firms. Geographically, European and 'global' respondents are relatively less supportive of the proposals.[1] The comments received indicate concerns not only with the proposals but with the motivation and rationale provided to support these changes.

10. There was more support from respondents in Africa and Asia-Pacific. The main supporters in these geographical areas were professional bodies and standard-setters and respondents in the energy and telecommunications industries. Respondents supportive of the proposals in other geographical regions were mainly individuals and those in the public sector, aerospace & defence and transportation services industries.

Core principle

11. The core principle (which requires a party to recognise its contractual rights and obligations) and the proposed changes to the descriptions of the different types of joint

[1] 'Global' is the geographical label we have used to describe respondents with global businesses, such as the major accounting firms.

arrangements were well received by respondents largely agreeing with the proposals, and by some respondents that largely disagreed with the proposals. Many respondents, however, noted that it was difficult to disagree with such a principle. Their concerns came primarily from its perceived implications and complex implementation.

12. Some of the respondents largely agreeing with the proposals stated that the core principle should help to provide a more realistic reflection of joint arrangements in the financial statements of the parties involved.

MAIN CONCERNS

Changes introduced are too far reaching: scope and execution of the project are questioned

13. Proposals such as the requirement to recognise contractual rights and obligations, the reference to 'rights of use' as an asset and the elimination of proportionate consolidation not only raised a number of concerns; they were also viewed as too far reaching to be addressed in a short-term project.

14. Many respondents believed that the proposed changes require further research and that a broader project on joint arrangements should be undertaken to explore and conclude on the best accounting method for joint arrangements. Please see comments relating to *Suggestions proposed by respondents* in paragraphs 41 - 42 of this paper.

Proposed changes are not adequately supported

15. Many respondents highlighted that the proposed changes to:

    (a) the terminology and definitions of the types of joint arrangement,

    (b) the accounting treatment based on the recognition of contractual rights and obligations, and

    (c) eliminate proportionate consolidation

    are not, or not adequately, justified in the Basis for Conclusions.

16. Many respondents stated that the exposure draft proposes to eliminate proportionate consolidation without any compelling justification of the equity method as the most appropriate method to use to account for joint ventures. A respondent further questioned how the equity method would be applied when no legal incorporated entity exists (ie unincorporated 'joint ventures' in the proposals). Some of these respondents stated that the retention of the equity method is justified solely on the grounds of substantial, but not full, convergence with US GAAP without any consideration of a conceptually sound approach to accounting for jointly controlled entities. On the other hand, the argument provided to support the elimination of proportionate consolidation (ie its inconsistency with the *Framework*) was unconvincing to many respondents. In this respect, some respondents stated that the *Framework* also requires faithful representation of the transactions and that the information provided meets the

qualitative characteristics of understandability, relevance, reliability and comparability. For these respondents, proportionate consolidation better meets these qualitative characteristics than the equity method.

17. Several respondents, which stated that they did not necessarily agree with the use of proportionate consolidation, did not agree that this option should be removed until there has been more detailed research into the implications of its removal and compelling reasons for its elimination. In this respect, one respondent stated that ‘it may be premature to eliminate proportionate consolidation from the accounting landscape while no firm conclusions have been reached on the future of equity accounting’.

Proposals are based on concepts currently being deliberated: risk of subsequent changes

18. Many respondents noted that a number of important concepts in the accounting for joint arrangements are currently being deliberated and reviewed in other active IASB projects. The concepts widely referred to are ‘control’ (Consolidation project), the ‘definition of assets and liabilities’ (Conceptual Frameworks project) and ‘rights of use’ (Leases project). They suggested that ED 9 is either prejudging the outcome of these other projects or has incorporated the preliminary conclusions reached on these projects in its drafting, which may not be appropriate.

19. Many respondents highlighted that completion of these other projects was necessary before making changes to current practice. It would avoid the new IFRS being based on concepts and principles that might be subject to change. According to these respondents, this could lead to diversity in practice and the risk of further changes which would be disruptive and costly to implement.

Enhancement of financial reporting

20. Many respondents expressed reservations as to whether the proposals would contribute to the enhancement of financial reporting. These reservations were mainly in connection with the elimination of proportionate consolidation. According to these respondents, the quality, usefulness and relevance of financial information will decrease and will not represent faithfully the substance and economic reality of an entity’s financial position and performance.

OTHER CONCERNS

Focus on ‘contractual rights and obligations’

21. Some respondents interpreted the focus on ‘contractual rights and obligations’ in the core principle as an indicator of adherence to legal form, rather than reflecting economic substance. They questioned whether the core principle may restrict the recognition of rights and obligations to only those that arise from contracts, implying a change in the asset and liability definitions.

22. Some view the perceived replacement of proportionate consolidation by the equity method as not achieving the recognition of the contractual rights and obligations of the venturers. Therefore, they view the proposals as inconsistent with the core principle.

Relevance of legal form to determine the accounting treatment

23. Some respondents remarked that, on the basis of the Illustrative Examples, the accounting for arrangements with identical economic substance appeared to be determined by the structure of the arrangement. Some of these respondents believed that the proposals implied that when a joint arrangement takes the form of an entity, the equity method applies. Several respondents did not understand the difference between a party's interest in a joint asset and an asset held in a jointly controlled entity. For those respondents, the legal form appeared to be a significant determining factor when deciding upon the accounting treatment.

Concerns about the new definitions of joint arrangements and accounting treatment proposed

24. Some respondents stated that the proposals do not reflect the essence of a joint arrangement. These respondents perceived that the proposals lessened the importance of 'joint control' by removing it from the definitions of joint arrangement, joint assets and joint operations.

25. Many respondents highlighted that the descriptions provided for the different types of joint arrangements were not clear. It was not immediately evident from the proposals how the different types of joint arrangements interact and are not mutually exclusive. The descriptions of 'joint assets' and 'joint ventures' and their corresponding accounting treatment raised some doubts among respondents. The main concern related to 'joint assets' was that the proposals were not clear on the classification of a party's interest in a joint asset in its financial statements. These respondents observed that different references such as a 'right to a share of a joint asset', a 'right to use' or a 'share of the joint asset' are used throughout the proposals, creating confusion about the accounting treatment to be applied. According to some respondents, the fact that the proposals state that an interest in a joint asset shall be recognised 'in accordance with applicable IFRSs' added even more confusion.

26. Many respondents had difficulty understanding that a 'joint venture', as defined in paragraph 15 of ED 9, is a joint arrangement or 'a part of joint arrangement'. Many respondents stated that the effect of this definition on the accounting treatment is not immediately apparent from the main body of the draft standard, but is revealed in the flowchart in Appendix B and in the Illustrative Examples. The notion of a joint venture also being a 'residual' was questioned by several respondents—they believed a 'joint venture' should be defined on a stand-alone basis. In addition, some respondents feared the non-recognition of a net liability as a residual when using the equity method, in situations in which the venturer had no legal or constructive obligation.

27. A few respondents questioned the need to distinguish between the different types of joint arrangements. They believed this could be superfluous given the underlying principle that parties to a joint arrangement should recognise their ‘contractual rights and obligations’ arising from the arrangement. Some respondents felt that the core principle required more discussion in a joint control environment before the concepts could be applied in complex situations. Indeed, some respondents believed that the accounting implications of the core principle had not been thoroughly considered. Several respondents believed that the difference between applying the core principle and proportionate consolidation should be made clearer in the standard. Some respondents perceived the recognition and measurement of ‘rights’ as a complex area and identified potential boundary issues between the proposals and IAS 17 *Leases* and IFRIC 4 *Determining whether an Arrangement contains a Lease*.

Elimination of proportionate consolidation

28. The elimination of proportionate consolidation drew extensive comment. The main arguments provided by the respondents largely disagreeing with its removal are that:

    (a) proportionate consolidation offers more useful information and provides a better reflection of the economic substance of the arrangements. For these respondents, management decision making and risk management are based on a detailed understanding of the underlying operations, assets, liabilities, cash flows and risks, and not on the share of net outcomes.

    (b) the elimination of proportionate consolidation will lead to the same accounting treatment for ‘joint control’ and ‘significant influence’, which is inappropriate.

    (c) the exposure draft does not offer compelling arguments for its removal.

29. The elimination of proportionate consolidation was also questioned by several respondents when comparing the approach taken by other standards in applying control with the one taken by the proposals. According to these respondents, an entity consolidates a special purpose entity (SPE) according to SIC 12 *Consolidation – Special Purpose Entities* when it is controlled by the entity or when it is deemed to have the majority of risks and rewards, irrespective of whether the entity is able to access freely the assets of the SPE. IAS 27 *Consolidated and Separate Financial Statements* requires an entity to consolidate a subsidiary with protected non-controlling interests even though the controlling entity cannot require the transfer of specific assets without the consent of the non-controlling shareholders. These respondents suggested that the criteria and / or indicators used to decide whether control exists for an SPE or a subsidiary with protected non-controlling interests should be applied equally to a venturer’s interest in a jointly controlled entity.

Disclosures

30. This section of the exposure draft received a lower volume of comments. Many respondents perceive the increase in disclosure requirements as being a consequence of the removal of proportionate consolidation. These respondents believe that key operating information is relegated to the notes, rendering the financial statements less relevant to users. Some of these respondents advocated requiring, for joint ventures, more extensive disclosure requirements, by requiring disclosure (in aggregate) of revenue, expenses, assets and liabilities using the same classifications as are used in the main financial statements.

31. Some respondents largely agreeing with the accounting proposals had concerns related to the disclosures requirements. They perceived the disclosures as being too onerous, particularly referring to paragraph 39(b)[2] of the exposure draft.

32. The proposal to restore to IAS 27 and IAS 28 the requirements to disclose a list and description of significant subsidiaries and associates was generally well received.

33. The proposal to require disclosure of current and non-current assets and liabilities of associates rather than total assets and liabilities was not strongly supported. Some respondents expressed doubts about the benefits and usefulness of the information to investors, since they would have no possibility to block decisions concerning the associate's asset and liability allocation. Respondents in the banking and real estate industries also challenged the requirement because their financial statements are presented according to liquidity or because their operating cycle is longer than one year.

US GAAP Convergence

34. According to many respondents, the proposals will not reduce differences between IFRS and US GAAP, but might lead to new differences.

35. These respondents stated that EITF-Issue No. 00-1 *Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures* permits the use of proportionate consolidation for unincorporated legal entities in either the construction or extractive industries where there is a longstanding practice of its use. These respondents believed that the proposals to eliminate proportionate consolidation would create divergence for those arrangements that meet the definition of a joint venture under the proposals but do not involve the establishment of a legal entity.

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[2] Paragraph 39 (b) of ED9: a venturer shall disclosure for each individually material joint venture, and in total for all other joint ventures summarised financial information, including, but not necessarily limited to, the venturer's interest in the amount of each of: (i) current assets, (ii) non-current assets, (iii) current liabilities, (iv) non-current liabilities, (v) revenues, and (vi) profit or loss.

36. In addition, differences would exist for those arrangements that involve the establishment of a legal entity but are considered a joint asset or joint operation according to the proposals. For these cases, the equity method would be applied under US GAAP, while recognition of contractual rights and obligations, with the residual accounted for under the equity method, would be required by the exposure draft.

Cost-benefit

37. Many respondents perceived that the benefits of the proposals would not outweigh its costs. These respondents highlighted three main sources of cost, for which there were no immediate direct benefits:

    (a) Costs generated by the need to maintain two parallel reporting systems for joint ventures—one internal reporting system based on proportionate consolidation and the second designed for IFRS compliance purposes. These respondents did not believe financial reporting would be enhanced by eliminating proportionate consolidation, therefore no immediate benefits were perceived to outweigh this cost.

    (b) Costs arising from the analysis that entities will be required to undertake in order to identify individual contractual rights and obligations to be recognised. These respondents stated that benefits from the proposed accounting treatment were not immediately visible.

    (c) Costs that could arise if entities restructure or rewrite their arrangements to convert joint ventures into joint assets or joint operations. For these respondents, the only benefit perceived would be compliance with an accounting standard, therefore failing the cost-benefit test.

Risks perceived as result of the implementation of ED 9

Effects on the business strategy of companies

38. Some respondents perceived that the implementation of ED 9 would have a negative effect on the strategy of companies that use joint ventures to enter strategic geographical areas for political, regulatory and economic reasons. Some of these respondents highlighted that a joint venture is often a compulsory business model in some operations or in emergent countries.

ED 9 might trigger legal modifications to the current contracts

39. Some respondents highlighted that the proposals might cause parties to seek to convert their contractual arrangements into joint operations or joint assets in order to apply a form of proportionate consolidation.

Joint ventures might be used as vehicles for derecognition of financial liabilities

40. A few respondents pointed out that since joint ventures will no longer contribute to some performance ratios, joint ventures might be used as vehicles for derecognition of financial liabilities.

SUGGESTIONS PROPOSED BY RESPONDENTS

Do not amend/replace IAS 31 at this time but develop a more robust accounting method for joint arrangements

41. Many respondents stated that it is premature to amend IAS 31 or to propose a new IFRS until a more robust and conceptually convincing approach to accounting for joint arrangements is presented. Some of these respondents believed that a broader project would need to be undertaken, to include the following:

    (a) An in-depth assessment of the specific characteristics of joint arrangements.

    (b) Development of the concepts of 'control' and 'joint control', analysing how 'joint control' interacts with 'control' and 'significance influence'.

    (c) Analysis and clarification of the inter-relationships with other projects such as the project on Leases and the Conceptual Frameworks project.

    (d) A comparative analysis of the different accounting methods taking into account the following: reflection of the substance and economic reality of the parties' interest in the joint arrangement, quality and usefulness of the financial information provided and consistency with the *Framework*.

    (e) Assessment of the practical application and implications of the changes proposed, including further guidance to ensure appropriate and consistent implementation of the proposals.

    These respondents suggested the postponement of any amendment or new IFRS on joint arrangements until these points are addressed.

42. Some of the respondents stated their preference for a joint project on joint arrangements between the IASB and FASB. One respondent observed that before issuing a new IFRS, it would be more appropriate to align the concept of control in US GAAP and IFRS to provide a suitable framework for joint venture accounting and achieve convergence.

Limit the choice available in IAS 31

43. Some respondents suggested that a better approach might be to limit the choice of accounting method available in IAS 31. These respondents believed a revised standard could provide guidance on which types of joint arrangements should be accounted for using proportionate consolidation and which should be accounted for using the equity method.

44. According to these respondents, it is worth considering whether the accounting could reflect the intention of an entity's involvement in a joint venture. Joint ventures set up for operational purposes (ie to expand the normal operations of the investing entity into new markets, etc.) are different from those set up as a financial investment under shared

control. The different nature and intention of these joint ventures could assist in establishing criteria to support different accounting treatments.

45. One of these respondents highlighted that the method used by management for internal reporting purposes could potentially be another factor to consider when choosing the most appropriate accounting method. This respondent believed that the possibility of using either the equity method or proportionate consolidation, depending on the nature and intention as well as the method used by management for internal reporting purposes, would provide users of financial statements with the most relevant information and faithful representation of the arrangement.

46. Some of these respondents suggested the revised standard could require management to justify its choice of method in its disclosures.

Interim solutions suggested until a broader approach on joint arrangements is finalised

47. Several respondents suggested that an interim solution would be to keep the option of accounting method and require additional disclosures in the notes to financial statements. According to these respondents, the additional disclosures could enable users to understand the nature of the reporting entity's activities that are carried out in jointly controlled entities, and would reduce concerns that financial statements prepared using proportionate consolidation could be misleading to users.

48. A few respondents suggested that consideration should be given to a presentation that is referred as the 'expanded equity method'. Under this method, the investor would present its proportionate share of the assets, liabilities, revenue and expenses of the joint venture in its financial statements, but with separate disclosure, and without combining these amounts directly with its fully consolidated assets and liabilities.

QUESTION FOR THE BOARD

Do you require any further clarification of comments received from respondents?

CONCLUSIONS AND MAIN SUGGESTIONS FROM THE STAFF

49. Based on the comments received, the staff concludes that the proposals have not been welcomed by a majority of the respondents for two main reasons:

    (a) Lack of clarity perceived in the articulation of the proposed requirements, which, as a consequence, has created confusion and concern among the respondents.

    (b) The respondents perceived the arguments given in the Basis for Conclusions to be weak or absent in support of the proposals.

50. The following activities are believed to be necessary as next steps:

    (a) Seek more feedback from respondents to the exposure draft and users of the financial statements, with the aim of acquiring a better understanding of joint arrangements in specific industries (i.e., power generation, food and beverage, chemicals and pharmaceuticals, real estate) and to increase the feedback received from users.

    (b) Perform further analysis of the relevance of 'joint control' in joint assets and joint operations.

    (c) Perform further comparative analysis of the equity method and proportionate consolidation, including which method better meets the definitions of elements and the qualitative characteristics of financial information in the *Framework*. This analysis would include clarification of the main differences between proportionate consolidation and recognition of contractual rights and obligations.

51. The staff will come back to you with a detailed timetable for redeliberations once we speak to respondents and users, and therefore, gain a better understanding of the concerns raised by some of the respondents.