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Proposed changes to accounting for joint ventures

On 13 September 2007, the International Accounting Standards Board (IASB) published for public comment Exposure Draft (ED) 9 proposing to replace IAS 31 **Interests in Joint Ventures** with a new Standard to be titled **Joint Arrangements**.

The IASB has requested comments on or before 11 January 2008.

The most significant changes proposed are:

- to shift the focus in accounting for joint arrangements away from the legal form of the arrangements and onto the contractual rights and obligations agreed by the parties; and
- to remove the choice currently available for accounting for jointly controlled entities (equity method or proportionate consolidation) by requiring parties to recognise both the individual assets to which they have rights and the liabilities for which they are responsible, even if the joint arrangement operates in a separate legal entity. If the parties only have a right to a share of the outcome of the activities, their net interest in the arrangement would be recognised using the equity method.

Ken Wild, Deloitte's global IFRS leader says:

"The IASB's proposals around a 'substance over form' approach to accounting for joint venture arrangements may in some cases address concerns about the elimination of the proportionate consolidation approach to recognising interests in jointly controlled entities. The proportionate consolidation approach has had a long history of support and use in some parts of the world, and its proposed elimination under ED 9 may provoke some staunch resistance as a result.

The approach under ED 9 requires legal structures to be ignored, in some cases bringing assets and liabilities held in separate legal entities directly onto the balance sheets of the venturers. This may provide entities with the opportunity to achieve accounting outcomes that resemble proportionate consolidation for some existing incorporated joint ventures.

This substance over form approach, whilst perhaps a pragmatic solution to the convergence with US GAAP so strongly pursued by the IASB and FASB, seems in some respects premature when considered in the light of the wider projects being undertaken by the IASB. This project is heavily dependent on the notion of 'unit of account' which is currently being debated by the IASB in its overall conceptual framework project. The **Framework for the Preparation and Presentation of Financial Statements** currently lacks guidance on how to account for 'parts' of assets or rights to particular aspects of assets."

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Shifting the focus away from legal form

General principles

A joint arrangement is a contractual arrangement whereby two or more parties undertake an economic activity together and share decision-making relating to that activity. Joint arrangements include joint assets, joint operations and joint ventures.

The ED proposes that the form of an arrangement should not be the most significant factor in the determination of the appropriate accounting for the arrangement. This is unlike the approach taken under IAS 31 which is closely aligned to the legal structure of joint venture arrangements, with only jointly controlled entities being singled out for equity accounting (or proportionate consolidation).

Adopting a 'substance over form' approach

The ED effectively adopts a 'substance over form' approach to the accounting for joint venture arrangements, focussing on the rights and obligations contractually agreed by the parties. The ED proposes that:

- a party to a joint arrangement should recognise its contractual rights and obligations (and the related income and expenses) in accordance with applicable IFRSs; and
- a party should recognise an interest in a joint venture (i.e. an interest in a share of the outcome generated by the activities of a group of assets and liabilities subject to joint control) using the equity method. Proportionate consolidation would not be permitted.

Types of joint arrangements

The table below summarises the three forms of joint arrangements contemplated by ED 9.

Type	Characteristics	Ownership of assets	Summary of accounting required
Joint operation	Involves the use of the assets and other resources of the parties, often to manufacture and sell a joint product.	Each party generally owns its own assets that it uses to create the joint product.	Recognise controlled assets and incurred liabilities, expenses incurred and share of revenues and expenses from the sale of goods or services by the joint arrangement.
Joint asset	Each party takes a share of the output from the asset and bears an agreed share of the costs incurred to operate the asset.	Each party has rights, and often has joint ownership of the assets used to generate the output.	Recognise share of joint assets, classified according to the nature of the asset, liabilities incurred (including those jointly incurred), revenue from the sale of share of output and expenses incurred.
Joint venture	Joint arrangement that is jointly controlled by the venturers. Each venturer is entitled to a share of the outcome of the activities of the joint venture.	Venturers do not have rights to individual assets or obligations for expenses of the venture.	Recognise the interest in the joint venture using the equity method unless an exemption applies (held for sale, exemption from equity accounting).

One arrangement can result in more than one category

The ED effectively requires an entity to take a holistic view of its joint arrangements. It also means that one arrangement can have multiple aspects and those aspects may be separately accounted for in some cases.

For instance, where joint arrangements are conducted through an entity, all associated agreements will need to be considered when assessing how to account for the arrangement – this could include leases granted or other rights afforded to one or more of the venturers, or guarantees provided effectively making venturers liable for liabilities. These contractual rights and obligations considered in the context of the overall arrangement may bring some assets and liabilities directly onto the balance sheet of the venturers.

Example
This example is based on Illustrative Example 3 in ED 9.

Three companies (venturers) jointly buy a 15-floor office building, with each floor having a separate legal title, allowing each floor to be sold separately. Each venturer has ownership of five floors and can use one floor for whatever purpose it chooses. Ownership of the other four floors held by each venturer are transferred to a separate company and then rented to third parties. The venturers jointly control the company and are not liable for any costs of the company.

Under the proposals in ED 9, the venturers must recognise two separate items:

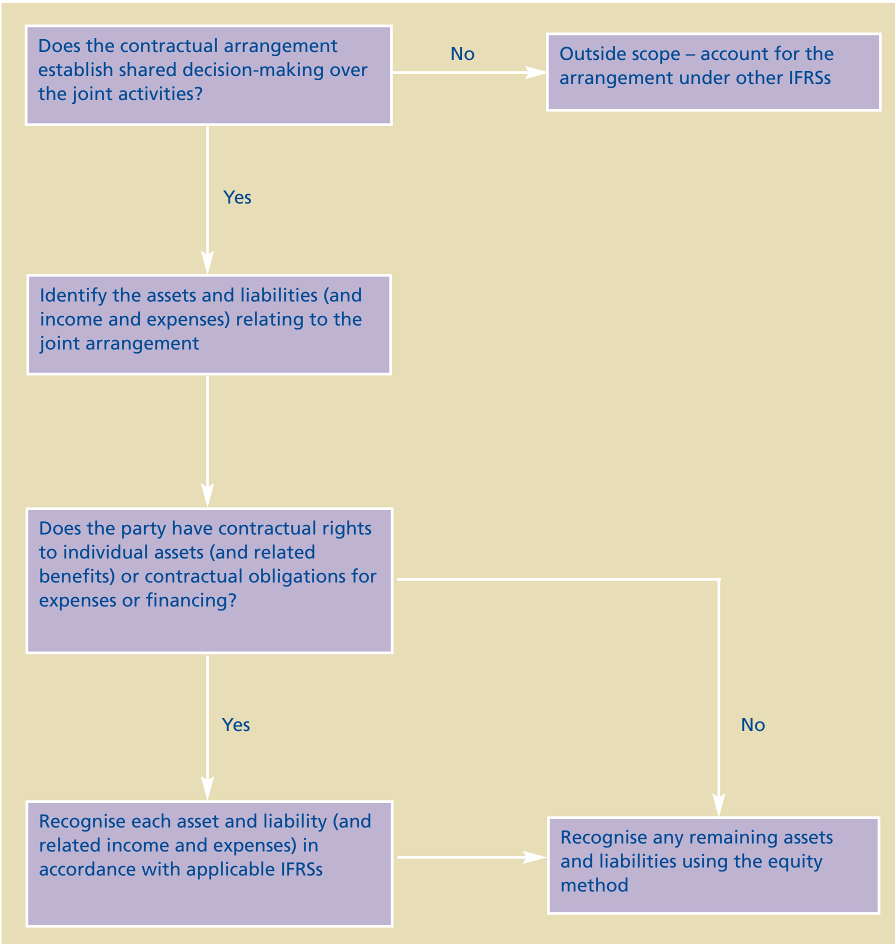
- a direct interest in the floor, accounted for under applicable IFRSs; and
- an interest in the company, equity accounted.

The same outcome would result if all 15 floors of the building were legally owned by the company, but with one floor leased to each venturer for the expected life of the building. This is because the rights afforded to each venturer through the lease produces an equivalent outcome in substance to direct ownership of the leased floor.

Under both scenarios, the joint venture company itself would not recognise the rights to use the floor which rest with the individual venturers.

Summary flowchart

The following flowchart (from the Application Guidance included in ED 9) illustrates how a party to a joint arrangement recognises its interests in the arrangement.



Expanded disclosure requirements

ED 9 proposes a number of enhanced disclosure requirements around joint arrangements, particularly in relation to joint ventures (which must be equity accounted under the ED). Consequential amendments are also proposed to IAS 28 **Investments in Associates** and IAS 27 **Consolidated and Separate Financial Statements** to align disclosure requirements between the various Standards.

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