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ED 9 Joint Arrangements
International Accounting Standards Board
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Dear Sir/Madam

**Invitation to Comment – Exposure Draft of ED 9 Joint Arrangements**

The global organisation of Ernst & Young is pleased to respond to the above Exposure Draft 9 (ED) *Joint Arrangements*.

Overall, we do not support ED 9 *Joint Arrangements* as a replacement to IAS 31 *Interests in Joint Ventures*, as we do not believe the ED is an improvement to the existing standard. In summary, our reasons for this are:

1. There is insufficient argument supporting why the equity method is appropriate and, in particular, preferable to the proportionate consolidation method.

2. The proposals introduce a level of complexity that will likely lead to divergence in practice.

3. ED 9 pre-empts and potentially contradicts the Board's ongoing deliberations with regard to the notion of 'control' of an entity and control of an asset which have not yet been finalised.

Ernst & Young generally supports the elimination of options in standards in order to achieve greater consistency in financial reporting. However, these decisions should be made after a thorough consideration of all available options. The Board has concluded that proportionate consolidation is not appropriate for accounting for joint ventures but has provided little or, in our opinion, only weak arguments for this. We are concerned that the equity method has not been subject to a thorough analysis – a method which we believe also has major shortcomings and inconsistencies with the *Framework*. Similarly, the Board has concluded that equity accounting is the appropriate way of accounting without considering other alternatives. We therefore believe that the Board should refrain from making any change to existing practice until a comprehensive analysis is performed of the above, which include obtaining a clear understanding of:

- the difference between an investment in an entity with joint control and an investment in an entity with significant influence;

- the reporting objectives for each type of investment; and

- the purpose of each accounting method – ie proportionate consolidation, equity method or any other option identified.

We believe the ED introduces additional complexity as it requires firstly the identification of joint operations and joint assets, with any residual interest to be accounted for as a 'joint venture'. This requirement may often lead to the situation that one arrangement consists of several types of joint arrangements. Whilst on the surface this requirement appears to be straight-forward, in practice this will require a complex exercise to identify each arrangement, identify the relevant assets and relevant liabilities relating to these arrangements, and identify the residual elements. We do not believe it is clear how the requirements of ED 9 interact with other standards, in particular the boundaries between ED 9 and IFRIC 4. We discuss this further in our response to question 2.

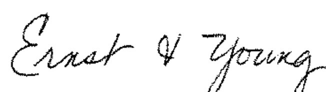
The Board is currently deliberating a number of concepts and principles that underlie accounting for joint ventures including the definition of 'an asset' and 'control', what constitutes the reporting entity, and methods of consolidation. It appears that some of the preliminary conclusions reached by the Board during these discussions have been incorporated into the thought process when drafting this ED. However, none of these preliminary conclusions has been exposed for full debate and consideration by the constituents. To base a standard on preliminary conclusions, which may change carries the risk of the standard containing inconsistencies with other standards, which may lead to diversity in practice and the risk of further changes which would be disruptive. We therefore urge the Board to accelerate its focus on completing those projects before making any changes to current practice.

This ED is part of the Short-term Convergence project undertaken by the Board and the Financial Accounting Standards Board, with one objective to reduce differences between International Financial Reporting Standards and US Generally Accepted Accounting Principles (US GAAP). We do not believe that this objective has been met as US GAAP allows proportionate consolidation for some industries. Similarly, the notion that an arrangement may contain more than one type of joint arrangement and that a 'joint venture' may be a residual does not exist in US GAAP.

For these reasons, we do not believe the Board should pursue the proposals contained in ED 9 at this time. Our answers to the specific questions and additional comments on the more specific details of the exposure draft are set out in the Appendix to this letter.

Should you wish to discuss the contents of this letter with us, please do not hesitate to contact Lynda Tomkins at the above address or on 020 79510241 or Pieter Dekker on 020 79512357.

Yours faithfully



## Appendix to the Comment Letter to ED 9 Joint Arrangements

**Question 1 – Do you agree with the proposal to change the way joint arrangements are described? If not, why?**

The definitions of the types of joint arrangements appear to be fundamentally the same as those contained in IAS 31. However, if these definitions are applied in the manner required by the ED, essentially in paragraphs 3 to 20, this is actually not the case. We believe that these changes introduce a level of complexity that is unwarranted and will create ambiguity. For example, joint ventures are also a 'residual' whenever an entity is involved, hence all such arrangements potentially have two forms to be accounted for.

Paragraph AG1 in Appendix B firstly requires the identification of joint operations and joint assets. Any remaining residual is accounted for as a joint venture. This paragraph, while integral to the standard, should in our opinion be part of the actual standard to supplement the basic principles explained in the text of the standard. However, there is no reference that a joint venture may be a 'residual' within paragraphs 3 through 20. In fact, much of the discussion in paragraphs 15 to 20 seems to be implying that a joint venture is a 'business', which is contradictory to a joint venture being a 'residual'. This ambiguity will lead to divergence in practice.

We further believe that the core principle used in ED 9 is too broad. It merely repeats what is stated in the *Framework*. It provides no assistance to understand how to apply the standard. We do believe it is useful to explain the reasons for a change from the current approach. We suggest that the principle should focus on how to separate and account for the various contractual rights and obligations that can arise in a joint arrangement.

**Question 2 – Do you agree that a party to a joint arrangement should recognise its contractual rights and obligations relating to the arrangement? If so do you think that the proposals in the exposure draft are consistent with and meet this objective? If not, why? What would be more appropriate?**

We agree in principle that a party to a joint arrangement should recognise its contractual rights and obligations relating to the arrangement rather than accounting for the form of the arrangement. However, as discussed above, we do not believe that this has been effectively achieved.

Additionally, the requirement of paragraphs 21 and 22 to recognise the interest in a joint operation or a joint asset in accordance '…with applicable IFRSs' is not clear. In many cases, such as in illustrative Example 2, the entity has a right of use. It is unclear how such a right should be accounted for; what is the 'applicable IFRS'? This highlights issues such as the boundary between IFRIC 4 *Determining whether an Arrangement contains a lease* / IAS 17 *Leases* and ED 9, and in particular the 'unit of account' to be considered. Whilst we understand that the intention of the ED was not to change existing practice, we nevertheless believe they may do so, due to the uncertainty the ED will create.

This is illustrated in Example 2 of the Draft Illustrative Examples. The jet aircraft is considered to be a joint asset and therefore each venturer is required to recognise its interest in the joint asset in accordance with applicable IFRSs. Because each venturer has a right of use of the aircraft for only a specific period of time, the venturer would look to IAS 17 / IFRIC 4 as the applicable IFRS, and therefore account for this as an operating lease. If the right of use itself was the unit of account, each

venturer would look to IAS 16 *Property, Plant and Equipment,* IAS 38 *Intangible Assets* or IAS 17. However, it may also be argued that in this case, the right of use as a unit of account does not give rise to a joint asset, because each venturer has its own right and, therefore, this would be out of scope of this ED.

By referring to the contractual rights of an arrangement, the ED seems to be redefining at this point what an asset is – restricting it to contractual circumstances. As we understand the Board is currently debating this and other definitions, we believe such a change at this stage is inappropriate.

We are also concerned with the consequences of applying equity accounting to what is effectively a 'residual' that is classified as a joint venture. In some cases an arrangement may give rise to a residual element that is only a liability. By limiting the recognition of any further liability to the conditions currently in place in IAS 28 *Investments in Associates* there is a danger that liabilities will not be recognised. Paragraph 26 indicates that '… a venturer **will often** have a legal or constructive obligation to support financially…'. We believe that this statement should be stronger and require that the share of a net liability in a joint venture is recognised in such circumstances.

This is illustrated in the variation of Example 2 of the Draft Illustrative Examples. The aircraft, that is purchased in the name of the company and financed by the parties to the arrangement, is a joint asset. If the joint venture finances the aircraft itself by a combination of equity and third party borrowings, such that the borrowings are not guaranteed by any of the entities, it would seem that the borrowings would represent the only residual to be accounted for as a joint venture. However, paragraph 26 would prevent the venturers from recognising their interest in the joint venture as a liability because there may not be a legal or constructive obligation to make payments on behalf of the joint venture.

**Question 3 – Do you agree that proportionate consolidation should be eliminated, bearing in mind that a party would recognise assets, liabilities, income and expenses if it has contractual rights and obligations relating to individual assets and liabilities of a joint arrangement? If not, why?**

Ernst & Young generally supports the elimination of options in standards in order to achieve greater consistency in financial reporting. The Board has concluded that equity accounting is the appropriate method of accounting for joint ventures, however, in our opinion have not sufficiently explained why this is the preferred method.

Paragraphs BC8 to BC10 of the Basis for Conclusion indicate that the consolidation of assets and liabilities not exclusively controlled by an entity is inconsistent with the definition of assets and liabilities in the *Framework*. Currently there are two notions of 'control' used throughout the standards - control of an entity and control of an asset. However it appears that both concepts are being used interchangeably within the ED. In addition, the reference to 'exclusive' control is misleading, as 'exclusive' does not exist in the current definition of an asset or liability. Rather this reflects the concepts that the Board are currently debating. The Board have argued that an entity should only be (proportionately) consolidated if the parent controls the assets of the subsidiary or the joint venture – eliminating the notion that there can be joint control. Under IAS 27 *Consolidated and Separate Financial Statements* an entity would be required to consolidate a subsidiary with non-controlling interests in a jurisdiction where minority shareholders are protected, such that the controlling entity cannot require the transfer of specific assets without the consent of the minority shareholders; in this case the entity may not have 'exclusive control' of the assets and liabilities.

Another example would be SIC 12 *Consolidation – Special Purpose Entities* whereby an SPE would also be consolidated when it is controlled by the entity, or when it has the majority of risk and rewards, even though the entity may not be able to access freely the assets of the SPE.

Furthermore, in paragraph BC14 of the Basis for Conclusion the Board acknowledges that there is a difference between joint control and significant influence, but has given no further consideration to the impact that these differences may have on the accounting objective. Rather this is considered to be '… outside the scope of this short-term project'. In our view, the differences between the two types of investment need to be analysed and fully understood in order to determine the objective in accounting for each type of investment, before any conclusion can be reached about an appropriate method. We recognise this may be outside of the scope of this short-term project, and consider this to be an indication that a short-term project of this nature is fraught with danger of reaching inappropriate conclusions, and introducing the need for further changes in the future.

BC14 states that because '… the equity method has been used to account for joint ventures in jurisdictions around the world for many years, it is appropriate to be used.' In our experience, the proportionate consolidation method has also been used in jurisdictions around the world for many years, and therefore this does not justify the selection of the equity method.

More importantly, when the 2003 version of IAS 31 was issued, the conceptual *Framework* (which was the same as it is today) stated in paragraph 40 that it 'does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity'. The Board has not clearly explained the reasons for their change in view, particularly given that the *Framework* has not changed.

**Question 4 – Do you agree with the disclosures proposed for this draft IFRS? If not, why? Are there any additional disclosures relating to joint arrangements that would be useful for users of financial statements?**

Whilst we do not believe that it is appropriate to continue with the accounting proposed in the ED, we have nonetheless addressed the specific questions relating to disclosure in the event that the Board does pursue its proposals.

We generally agree with the disclosures proposed in this ED. We support the alignment of the disclosures required for joint ventures with those required for associates if equity accounting is used to account for joint ventures. We believe, however, that if a full understanding of the differences between an investment in an entity subject to joint control and one subject to significant influence was obtained, additional disclosure requirements for joint ventures may be appropriate. We also question why certain disclosures currently required by IAS 31 are no longer required, in particular paragraphs 54 and 55 of IAS 31 relating to contingent liabilities and capital commitments incurred by the joint venture. No explanation has been provided by the Board for this change.

Paragraph 39(b) requires summarised financial information of the venturer's interest to be disclosed for each individually material joint venture. We believe that this information may increase the understandability of the financial statements. However, in order to increase the relevance and consistency of this disclosure requirement, we recommend that paragraph 39(b) clearly stipulates that the financial information is prepared in accordance with IFRS.

The same paragraph also requires disclosure of summarised financial information 'in total for all non-material joint ventures'. We do not believe that this is appropriate, as aggregating information relating to several joint ventures does not give rise to any meaningful disclosure. We recommend that this is deleted.

**Question 5 – Do you agree with the proposal to restore to IAS 27 and IAS 28 the requirements to disclose a list and description of significant subsidiaries and associates? If not, why?**

We support the proposal to restore the requirements in IAS 27 and IAS 28 to disclose a list and description of significant subsidiaries and associates. We believe that this information would provide useful additional information to the reader of the financial statements as it allows the reader to get more information about the various significant subsidiaries and associates and their activities.

**Question 6 – Do you agree that it is more useful to users if an entity discloses current and non-current assets and liabilities of associates than it is if the entity discloses total assets and liabilities? If not, why?**

We agree that in general it is more useful to users if an entity discloses current and non-current assets and liabilities of associates. However, as noted in our response to question 4 we believe that a full understanding of the difference between an investment in an entity subject to joint control and one subject to significant influence needs to be undertaken to reach a conclusion on this particular matter.

## Additional comments to the exposure draft

**Paragraph 26**
In some cases in the ED (e.g. paragraph 26), references are made to IAS 28, but the paragraph uses different words to those in IAS 28. In order to increase understandability, ensure consistency and avoid confusion we recommend that either the exact words of IAS 28 are repeated or a cross reference is inserted.

**Paragraph 27**
Paragraph 27 refers to paragraph 22 of IAS 28 for gains or losses resulting from transactions between a venturer and the joint venture and incorporates the consensus of SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*. However, the paragraph does not distinguish between realised and unrealised gains and losses for non-monetary contributions by the venturer as SIC-13 did and, therefore, changes the accounting for such transactions. Although we agree that gains and losses on non-monetary assets contributed to a joint venture that are attributable to the equity interest of other venturers, should be recognised in profit or loss, regardless of whether they are deemed to be realised or unrealised, the reasons for this amendment should be clearly stated in the Basis for Conclusions.

**Paragraph 29**
This paragraph requires that when a venturer ceases to have joint control over a joint venture but retains significant influence, such that the investor will continue to account for its investment using the equity accounting method both before and after the loss of joint control, the investor does not re-measure the retained interest to fair value. Paragraph BC19 of the Basis for Conclusion states that this approach has been chosen for practical reasons. Whilst we agree that, if equity accounting is considered to be the appropriate method of accounting, this approach is practical, it is inconsistent with the approach outlined in the revised IAS 27 and the consequential amendments to IAS 31,

which should shortly be issued. This will require a non-controlling equity investment in a former subsidiary (or joint venture) to be re-measured to fair value when the parent loses control (or joint control) of the subsidiary (or joint venture). In paragraph BC27Y of the near final draft of revised IAS27 the Board notes that the loss of control of a subsidiary (or joint control of a joint venture) is a significant economic event which triggers re-measurement. Therefore, the proposals in ED 9 introduce an inconsistency with other standards.

**Paragraph 35**
This paragraph requires application of paragraphs 37-42 of IAS 27 to an interest in a joint venture if separate financial statements are prepared. However, paragraph 40 of IAS 27 refers to disclosures required in consolidated financial statements. Therefore, paragraph 35 of ED 9 should only refer to paragraphs 37-39 and 41-42 of IAS 27.

**Illustrative Examples to ED 9**
We support the inclusion of illustrative examples that show how to identify the different types of joint arrangements within an arrangement. However, in our view some of the examples should be expanded to include the accounting entries, as the accounting is not always intuitive. This is particularly true in those cases where certain assets have been 'stripped out' of an entity and equity accounting is applied to the residual, such as in examples 2 and 3.

**Example 2 – Joint interest in a jet aircraft**
Paragraph IE 15 of the Draft Illustrative Examples indicates that introducing a company to purchase the jet aircraft, 'should have little effect on the accounting by the five advertising companies'. We believe this statement is confusing and inaccurate, and recommend that it is deleted.

**Example 3 – Jointly held office building**
Paragraph IE 25 of the Draft Illustrative Examples states that each venturer leases one floor from the company for the whole expected useful life of the building. In other words, each venturer has entered into a finance lease with the joint venture. This fact should be made more explicit. It is only in the case of a finance lease that the venturer recognises the leased floor on its balance sheet and, hence, the accounting would only then be similar as if the venturer had a 'direct' interest in the floor. IE27 however indicates that the entity has a 'direct' interest in the floor, when in fact it has only a finance lease.

**Example 5 – Mining unitisation arrangement**

Paragraph IE46 of the Draft Illustrative Examples states that all parties participate equally in the costs of and benefits obtained by the arrangement, and that parties agree to share equally the risk that one of the areas contributed to the arrangement does not have economically viable reserves. This variation may be helpful to illustrate that regardless of the change in the fact pattern the joint arrangement still involves joint assets. However, we are of the view that the fact pattern in the variations do not reflect unitisation arrangements seen in practice and should therefore be deleted. The initial example in paragraph IE39-IE41 represents what we have seen in practice.

**Example 6 – Oil and gas 'farm-in' arrangement**
This example talks about an oil and gas "farm-in" arrangement. We are of the view this is rarely seen in practice and rather artificial. However, the variation to the example is more realistic and, we therefore suggest to use the variation as the main example.

**Example 7 – Illustrative disclosures of joint arrangements**
This example shows how disclosures required by this ED may be presented in a set of financial statements. Paragraph 39(b) requires that summarised financial information of the venturer's interest of each individually material joint venture, and in total for all other joint ventures is to be disclosed. However, paragraph IE64 of the draft illustrative examples currently provides information about the total amount of assets and liabilities, being inconsistent with the requirements of paragraph 39(b).