EFRAG
European Financial Reporting Advisory Group

6 February, 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UK

Dear Sir or Madam,

Re: Exposure Draft ED 9 Joint Arrangements

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft ED 9 *Joint Arrangements*. This letter is submitted in EFRAG's capacity as a contributor to IASB's and IFRIC's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issue.

We have structured our response as follows. We outline below the main issues we see with the proposals. In appendix 1 we provide responses to the questions posed in the exposure draft. In appendix 2 we provide some suggestions for different presentations of the income statement and profit and loss account which could provide useful information to the user of financial statements if proportionate consolidation is eliminated.

Our main comments are as follows:

1 We do not support the proposed elimination of proportionate consolidation.

In our view, the case for eliminating proportionate consolidation is not sufficiently compelling. We think that, when trying to eliminate options in standards, standard-setters need first to evaluate all of the options against the same relevant criteria. It appears in this case that only the proportionate consolidation option has been subjected to this type of review. In our view, were the other option (the equity method) to be subjected to a proper evaluation, it would have been found wanting. The elements behind our view are as follows.

- The usefulness of the information provided. The stated objective of the project is to improve financial reporting, yet we are not convinced that prohibiting the use of proportionate consolidation would achieve that objective.

- Inconsistencies with the Framework. Although the ED argues that proportionate consolidation is inconsistent with the Framework, we are not convinced, particularly as we agree with the statement in existing IAS 31 *Interests in Joint Ventures* that proportionate consolidation reflects the substance and economic reality of joint venture arrangements.

- A possible need for further changes. Many of the concepts and principles underlying the treatment of joint ventures—for example, the notion of the reporting entity, consolidation methods, and the definitions of assets and liabilities—are currently under review in other projects. If those concepts and principles are revised as a result of those projects, further changes might be needed to joint venture accounting and that could be very disruptive.

- Convergence with US GAAP. Although the ED argues that its proposals achieve convergence in principle with US GAAP, we do not believe that the degree of convergence achieved will be sufficient to justify the changes proposed.

2 We suggest a better approach might be to limit the choice available under IAS 31.

Currently entities have a free choice between proportionate consolidation and equity accounting. We think it would be helpful to users if IAS 31 were amended to direct that choice. In particular, there could be a requirement for the management of the entity to choose whichever of the two accounting methods is the most appropriate, taking into account the circumstances of the reporting entity and the nature of the interest in the jointly-controlled entity. The revised standard could provide criteria that would direct the management of the reporting entity in its choice of the most appropriate method. The criteria could be, for example, whether the interest was in an operating activity or an investment.

3 We think that currently users are often not getting sufficient information and we think that will also be the case under these proposals

In our view the single most important issue concerning IAS 31 is whether users are provided with the information they need. The discussions we have had with users and others suggest to us that, whichever accounting method is chosen, that is not currently the case—and that it will continue not to be the case under the proposals.

It is important that sufficient disclosure is provided to allow the user to understand the nature and extent of the reporting entity's activities that are carried out in jointly-controlled entities. Yet the equity method does not always give users a good appreciation of the scale of the activities (because of the netting-off of elements in the primary financial statements). Equally, proportionate consolidation typically involves aggregating controlled and jointly-controlled items in the same lines of the primary statements, thereby often making it unclear to users what proportion of the assets and liabilities are subject to joint control or sole control. We discuss this in our response to Question 4.

If you would like further clarification of the points raised in this letter, either Gregory Hodgkiss or I would be happy to discuss these further with you.

Yours faithfully

Stig Enevoldsen
EFRAG, Chairman

APPENDIX 1

EFRAG's responses to the questions asked in ED 9

NB The text of the invitation to comment is reproduced in bold italics below.

General Comment

Question 1 – Definitions and terminology

The exposure draft proposes that the IFRS should be applied to arrangements in which decisions are shared by the parties to the arrangement. The exposure draft identifies three types of joint arrangement—joint operations, joint assets and joint ventures. A party to an arrangement may have an interest in a joint operation or joint asset, as well as an interest in a joint venture. Joint ventures are subject to joint control (see paragraphs 3–6 and 8–20 and Appendix A of the draft IFRS and paragraphs BC16–BC18 of the Basis for Conclusions). Question 1: Do you agree with the proposal to change the way joint arrangements are described? If not, why?

EFRAG's Response:

1.1 It appears from discussions with our constituents that the descriptions of current IAS 31 *Joint Ventures* (IAS 31) are not causing difficulty in practice. Some constituents suggested that the renaming and changing of the descriptions of the types of joint arrangement along the lines suggested in ED 9 might actually be a source of confusion in the future. For those reasons EFRAG does not agree with the proposal to change the way joint arrangements are described.

Other comments

1.2 We find the description of the joint venture, as laid out in paragraphs 15 to 20 of ED 9, to be confusing. In particular, paragraph 18 does not seem to follow on logically from the preceding paragraphs, but to exist in parallel. In our reading, the description (and the definition) of a business[1] (as defined in Appendix A to IFRS 3 and Appendix A to ED 9) is very similar to the description of a joint venture. ED 9.15 states that the venturer's interest is in its share of the outcome of the activities of the joint venture and ED 9.17 states that a joint venture controls assets, incurs liabilities and expenses and earns revenue. These descriptions of a joint venture appear to us to be so similar to the definitions of a business that it may be clearer to combine them and describe an interest in a joint venture as an interest in a business over which the venturer enjoys joint control (as defined in Appendix A to ED 9).

1.3 Notwithstanding the point made in the paragraph above, we see a further potential point of confusion in the description of a joint venture. Paragraphs IN8 and 15 to 20 define a joint venture as a set of activities in which the venturer's interest is limited to an interest in the net outcome. However, in addition to this description, the flowchart in Appendix B seems to imply that a joint venture can also be a residual, i.e., when all the individual assets and obligations have been recognised by the party to the arrangement "any remaining assets and liabilities" represent an interest

[1] An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

in a joint venture to be accounted for using the equity method. We are concerned about defining a joint venture by default in this way, as we think it is always clearer to identify an arrangement positively. Furthermore, we do not believe that US GAAP has this notion and thus this might lead to a divergence in GAAP. Finally, we find it hard to understand how the disclosures required for joint ventures could be useful in respect of such a residual.

1.4 Although one of the objectives of ED 9 is to move away from the current situation of treating the form of the arrangement as the most important factor in determining the accounting, we are not sure that this has been achieved. In the variation to illustrative example 2, for example, legal ownership of the aircraft by a jointly-controlled company has led to a right to a residual asset which has to be accounted for as part of the joint venture rather than as a joint asset. The economic substance of the whole arrangement has not changed, however. In example 4 the accounting for the arrangement is determined by the fact that an entity has been set up to own and operate the shopping centre. The accounting would be different if each venturer continued to own 50% of the shopping centre and had set up a jointly-controlled operating entity, and different again if the centre was operated by one of the venturers and revenues and expenses billed between the venturers. The economic substance of the arrangement is really the same in all cases, but the ED appears to place more weight on the form of the joint arrangements as the determining factor in deciding upon the accounting. This may be the right conclusion, but in view of the stated objective we believe that more explanation is required to facilitate understanding of the principles by constituents.

1.5 According to paragraph BC20 of ED 9 the Board proposes to incorporate into the IFRS the consensus of SIC13 *Jointly Controlled Entities- Non-Monetary Contributions by Venturers* (SIC13). The requirements of SIC 13 and IAS 31 paragraphs 48 – 50 in respect of transactions between a venturer and a joint venture have been replaced by a reference in paragraph 27 of ED 9 to paragraph 22 of IAS 28. We wonder whether this will be sufficient guidance once SIC 13 and current IAS 31 have been withdrawn, or whether the guidance of the consensus of SIC 13 should also be incorporated into IAS 28. As an illustration of this, while SIC-13 prohibits recognition of a gain or loss when a contribution to a joint venture lacks commercial substance, there is no corresponding requirement in paragraph 22 of IAS 28. If this change is intentional then it would be helpful to understand why the change improves the quality of financial reporting.

1.6 Paragraphs 52 and 53 of IAS 31 in respect of the joint venture operator's fees have been removed from ED 9, presumably on the grounds that the accounting for these is obvious. We believe it may still be useful to specify that such fees should be accounted for as an expense of the joint venture and as revenue in accordance with IAS 18 for the operator. This would prevent diversity in accounting from arising in practice, such as in the case of the operator being remunerated by special dividends or a disproportionate share of the net income. In the absence of guidance these could be accounted for as dividends.

1.7 We reviewed ED 9's illustrative examples and concluded that the examples were not sufficiently detailed nor were they explained clearly enough to allow preparers to understand the principles that had been applied and what the accounting was in concrete terms. For example, Example 2 states that the rights to access to an asset and its residual value would be recognised "in accordance with applicable IFRSs". The variant to this example states that it should have "little effect" on the accounting by the venturers, even though the latter have provided financing to the joint venture, which could be shown as an investment in the joint venture in accordance with paragraph 20 of ED 9, (and would be shown as such under US

GAAP), instead of as an item of property, plant and equipment as in the first part of the example. As another illustration of this, example 4 surprised many members, who saw this as a case where the substance was that of a joint asset, as discussed in paragraph 1.4 above. We believe that the illustrative examples would be much more understandable and helpful if the "applicable IFRSs" were specified and the accounting described in terms of accounting entries.

1.8 We note that in paragraph 23(b) no direction is given as to how the interest in a joint venture should be treated by an entity which is allowed not to present consolidated financial statements. Our understanding of the interaction between ED 9 and IAS 27 is that a parent which elects not to present consolidated financial statements has (in accordance with IAS 27 paragraphs 37-42) to account for its investments in jointly-controlled entities either at cost or in accordance with IAS 39. A venturer which is not parent because it has no subsidiaries appears to be subject to the same requirement. We think that such parents and venturers should have the option to use the equity method or proportionate consolidation in their separate financial statements if, in the judgement of the entity's management, the scope of this activity warrants it. In any event, it could be helpful to understand why it is not necessary to provide such guidance in ED 9.

1.9 Finally, we think it would be useful for the future standard to provide guidance on how to deal with changes in ownership interest in a joint arrangement which do not result in a loss of joint control or the ability to share in decision making.

Questions 2 and 3 – Accounting for joint arrangements

The exposure draft proposes:

- ***that the form of the arrangement should not be treated as the most significant factor in determining the accounting.***
- ***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.***
- ***that a party should recognise an interest in a joint venture (ie 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.***

(See paragraphs 3–7 and 21–23 of the draft IFRS and paragraphs BC5–BC15 of the Basis for Conclusions.)

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?

EFRAG's Response

2.1 The core principle of ED 9 is that "parties to a joint arrangement recognise their contractual rights and obligations arising from the arrangement". Although at first sight it would appear to be difficult to disagree with this as a principle, the wording of this actually raises a number of questions about whether the definitions of assets and liabilities have been modified by the core principle.

(a) The use of the words "*contractual* rights" seems strange bearing in mind the definition of an asset envisages assets based on other types of rights. For example, we note that IAS 38 *Intangible assets* paragraph 12 states that "An asset meets the identifiability criterion in the definition of an intangible asset when it: […] (b) arises from contractual or other legal rights, […]". IAS 38.13 goes on to state that "An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control […] normally stems from legal rights that are enforceable in a court of law. […] However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way." Thus ED 9 appears to be restricting the notion of control over an asset to control that comes about as a result of a contract, whereas IAS 38 states that one can have legal rights to an asset without a contract, and that control can even exist in the absence of legal rights.

Similarly, it seems strange to refer only to "contractual obligations" (assuming that is the intention, see paragraph 7.9) when, as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* makes clear, liabilities can be based on legal obligations other than contractual obligations and even on non-legal obligations (constructive obligations).

If the definitions of assets and liabilities have been deliberately set aside, the Basis for Conclusions should explain why and how the terms differ. On the other hand, if it is not deliberate, perhaps the core principle should be amended so that it refers to, say, "the assets and liabilities arising from the contractual arrangements".

(b) Some commentators have seen in ED 9 a change in the nature of the joint asset to be recognised. The effect of the core principle taken in conjunction with illustrative example 2 is interpreted to mean that the joint asset to be recognised is an intangible right of use instead of a share of an item of property, plant and equipment. This could have important implications for how the asset is viewed, so it would be helpful if the nature of the joint asset could be clarified.

2.2 Given the questions we have about whether the core principle represents a change in the definitions of assets and liabilities, we cannot conclude on whether the proposals in the ED are consistent with the objective that a party to a joint arrangement should recognise its contractual rights and obligations relating to the arrangement.

Other comments

2.3 It would, of course, be very convenient if the "core principle" behind a particular accounting standard could always be summed up in a short phrase or single paragraph, but we doubt whether this is achievable in most cases. Notwithstanding the need for clarification discussed above, the core principle of ED 9 could equally be applied to accounting for leases or indeed most aspects of the recognition of assets and liabilities in financial statements, and we therefore find it too generic to be of real value in this (draft) IFRS. We believe, therefore, it should be removed from any final standard that may be developed. An overarching principle like this might best be stated in a conceptual statement such as the Framework.

2.4 What might be useful, we think, is for the proposed standard to state that it requires a careful analysis of the rights and obligations related to the joint arrangements to be made in order to identify those assets, liabilities, revenue and expenses which are those of the entity which is a party to the arrangement.

2.5 From the discussions we have had with preparers and others, one of the issues that can be difficult to grasp is exactly what the difference in concept is between an entity recognising its own assets/liabilities/revenue/expense etc. and the entity's proportionate consolidation of another entity's assets/liabilities etc., even though the resulting presentation might seem to be the same. It might help the proposed standard gain wider acceptance were this to be explained in the Basis for Conclusions

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?

EFRAG's Response

3.1 We do not agree. We believe that proportionate consolidation should not be eliminated until a comprehensive review of the accounting and reporting of joint ventures has been completed and has concluded that proportionate consolidation is the option that should be eliminated. We have reached this view because, in summary, we are concerned about the implications of the ED's proposals for the quality of the information provided, because we believe that it is premature to eliminate proportionate consolidation on the grounds of inconsistency with the *Framework for the Preparation and Presentation of Financial Statements* (the Framework) when that Framework—including a number of notions of fundamental importance to the proportionate consolidation issue that are still under debate—is still under review, and because the proposals will not lead to full convergence with US GAAP. Therefore, we find the arguments in the Basis for Conclusions insufficient to justify a change which will be disruptive for both preparers and users.

The quality of the financial information provided

3.2 This project's stated objective is to improve financial reporting for those activities within the scope of IAS 31 *Interests in Joint Ventures* (ED 9 BC3). We strongly support this objective. Yet if that objective is to be met, it is important to evaluate all the options to identify which options are the most useful and which the least useful, before deciding which to eliminate. However, as far as we can tell from the ED's Basis for Conclusions, this has not been done. We believe it follows that there is insufficient basis for the proposal to eliminate proportionate consolidation as an option.

3.3 We recognise that reducing the choice of accounting options can lead to a reduction in the costs of users, but believe that in evaluating proposals for such reductions we need still to consider the implications for the quality of information provided. Similarly, although we support the objectives of the IFRS/US GAAP convergence project (because the project has the potential to reduce costs for both preparers and users), it is still important to consider the implications of any convergence proposal for the quality of the information provided.

3.4 We note that to a large extent what the proposals will in effect do is take information that is currently included in the balance sheet and instead disclose it in the notes. This seems unfortunate because it is the primary financial statements that receive the most attention from users (as they provide the most concise overall view of the entity's performance) and which therefore should wherever possible contain the most useful information. Although the ED is proposing that the disclosures provided about joint ventures should be enhanced, it is widely accepted (and stated in IAS 1) that note disclosure cannot compensate for accounting methods which do not reflect the substance of the entity's performance and financial position.

3.5 This issue is important because, either as the result of their choice of business model or because joint ventures are the only way to gain access to some countries, many consolidated groups carry out large parts of their activity through joint ventures. As an example, joint arrangements can represent as much as 70% of the activity of some major French groups. In such groups, management's involvement in the activities of the joint ventures often goes well beyond a share in decision-making at joint venture board level, and frequently cash flows in and out of the venture are significant and are shared among the venturers on a daily basis. Management makes decisions about the group's involvement with the joint venture and participates in the decision making about the venture's operations based on a detailed understanding of the underlying operations, assets, liabilities, cash flows and risks, not on the share of net outcomes. Where the joint venture's operations are so closely linked to those of the venturer, it can be argued that proportionate consolidation provides the user with a fuller view of the scale of the operations managed, and the risks borne, by the group, and, in the right circumstances, is a better indicator of future cash flows than equity accounting.

3.6 We understand that, for the reasons discussed above, many EU preparers use proportionate consolidation for their internal reporting, particularly in those countries where proportionate consolidation was established practice under the national GAAP. Elimination of proportionate consolidation would lead to a disconnection between the way the group is reported internally and externally. If proportionate consolidation is eliminated, we believe that some preparers will nonetheless continue to use it for their internal reporting and for their operating segment presentation, as allowed by IFRS 8. It might be expected that this would lead to wider use of non-GAAP measures as a more relevant set of indicators in management's discussion and analysis of the results.

3.7 Based on our discussions with users (including EFRAG's User Panel) and preparers (including EFRAG's Joint Venture Working Group), it is our understanding that the use of the proportionate consolidation option to account for joint ventures is widely thought to produce useful, albeit not perfect, information.

Is proportionate consolidation inconsistent with the Framework?

3.8 In paragraph BC8 of ED 9 the IASB argues that proportionate consolidation is not appropriate because it results in an entity's recognising as assets and liabilities a proportion of items that it does not control or for which it has no obligation. Paragraph BC9 also states that this accounting is "not consistent with the Framework, which defines assets in terms of exclusive control and liabilities in terms of present obligations." We do not find these arguments compelling for two main reasons.

(a) Although ED 9's rationale focuses on the definitions of assets and liabilities in the Framework, the Framework also covers other matters that are relevant to the discussion, including the objectives and the qualitative characteristics of financial information. (This is relevant because entities that currently use proportionate consolidation seem to believe that it may be more relevant and reliable (i.e. it reflects the substance) than the equity method, and that it provides more useful information.) The Framework does not attempt to establish a hierarchy among these various aspects, so it is not clear that the definitions have precedence over the qualitative characteristics. (This is discussed further below under 'Qualitative characteristics'.) However, even if it is decided that the asset and liability definitions have precedence over the qualitative characteristics, it does not follow that proportionate consolidation is inconsistent with the Framework. That is because the existing Framework says almost nothing about the reporting entity concept or about methods of consolidation. There also remains considerably uncertainty about aspects of the asset definition. The reporting entity notion, methods of consolidation and the asset definition are also discussed further below.

Qualitative characteristics

3.9 The current IAS 31 maintains that proportionate consolidation is the better method of accounting for joint venture entities because it gives the better representation of the substance of the arrangement. For example, IAS 31.32 states that "when recognising an interest in a jointly controlled entity, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has *control over its share of future economic benefits* through its share of the assets and liabilities of the venture. This *substance and economic reality* are reflected in the consolidated financial statements of the venturer when the venturer recognises its interests in the assets, liabilities, income and expenses of the jointly controlled entity *using* one of the two reporting formats for *proportionate consolidation*…" (Emphasis added). IAS 31.40 states "This Standard 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, that is to say, *control over the venturer's share of the future economic benefits*." This wording seems to have been chosen to make it clear that proportionate consolidation is consistent with the Framework, particularly its reliability notion and its definitions of assets and liabilities[2].

3.10 Presumably the IASB no longer shares that view. However, bearing in mind what IAS 31 says, and the fact that the Framework has not changed since IAS 31 was issued, we would have expected the IASB to provide compelling arguments to support the assertions that proportionate consolidation is fundamentally inconsistent with the Framework. We believe that the Basis for Conclusions of ED 9 does not do this.

The reporting entity and consolidation

3.11 We believe that the method of accounting for jointly-controlled entities is primarily a question of the scope of the reporting entity and methods of consolidation. Yet these are issues on which the Framework is particularly weak. Indeed, the Framework does not discuss the reporting entity notion or consolidation at all, which makes it difficult in our view to argue that some or all of a joint venture is not part of the reporting entity.

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[2] An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. [IASB Framework, paragraph 49] and
In assessing whether an item meets the definition of an asset, liability or equity, attention need to be given to its underlying substance and economic reality and not merely its legal form. [IASB Framework, paragraph 51]

3.12 The assets and liabilities that are recognised in the balance sheet are those of the reporting entity. It is therefore necessary first to identify the reporting entity, addressing the specific issue in the context of ED 9 as to whether joint control is sufficient to bring the jointly-controlled entity into the scope of consolidation. If it is determined that the jointly-controlled entity is part of the reporting entity then a suitable consolidation method must be found. It is only at this point, in our view, that paragraph 49(a) of the Framework becomes relevant to the question of what assets and liabilities are recognised in the reporting entity's financial statements.

3.13 When a parent controls a subsidiary, the assets and liabilities of the subsidiary are combined line by line with those of the parent. We believe that this is done regardless of any restrictions over the parent's ability to deploy or direct the use of the subsidiary's assets. Such restrictions often exist for subsidiaries of foreign entities in various countries. We are not convinced, therefore, by the argument of BC9, which states that proportionate consolidation is not consistent with the Framework because it could lead, for example, to the recognition of cash balances that the reporting entity does not have the ability to direct or deploy without the agreement of other parties.

3.14 SIC 12 Consolidation-Special Purpose Entities requires an SPE to be consolidated when the substance of the relationship is that an entity controls the SPE. Paragraph 10 of the Interpretation sets out examples of circumstances which indicate that an SPE is controlled by an entity. These examples are largely based on whether the entity obtains benefits (or the majority of the benefits) from the SPE and is exposed to the risks of ownership or incident to the activity of the SPE, rather than whether it has control over the individual assets and liabilities of the SPE. We note that those 'indicators that control exists' apply equally to the venturer's interest in a jointly controlled entity. We believe the IASB needs to explain why the presence of those indicators is sufficient for an SPE to be consolidated despite the absence of any other evidence that control exists whereas their presence is not sufficient in the case of a jointly-controlled entity.

The asset definition

3.15 The work the IASB has carried out over the last year on its asset definition has highlighted a number of concerns that the IASB has about the definition and we think some of those concerns are relevant to the proportionate consolidation debate. For example, bearing in mind the concerns about what is meant by control of an asset, we wonder whether it is really appropriate at this time for ED 9 to be drawing such a fundamental distinction between the quality of control that an entity enjoys over a joint asset and that which it enjoys over an asset owned by a joint venture which the entity jointly controls.

3.16 We note that the question of what "control" means in the context of an asset is a difficult one in several areas of accounting, and has caused problems in connection with, for example, IFRS 4 *Insurance Contracts* and IFRIC 12 *Service Concession Arrangements*. Paragraph BC8 of ED 9 makes no distinction between 'control' over an asset and 'control' over an entity. Although there are definitions of "control" in several IFRSs, these are all used in the context of control over an entity. The definition of an asset in paragraph 49(a) of the Framework[3] does not include the

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[3] Existing IASB and FASB Definitions of an Asset

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. [IASB Framework, paragraph 49] word “exclusive” in its definition, and this notion is not used in this context anywhere else in the Framework, as far as we can see. We think that the Board may be pre-judging the outcome of the work it is carrying out on the asset definition as part of its Framework project on the definition of in concluding that “control” in the Framework can only mean “exclusive control” and never “joint control”. Moreover, we note that the latest working definition of an asset included in the papers for the 16 October 2007 IASB/FASB meeting also does not seem to require exclusive control[4].

3.17 Bearing all that in mind, we question whether the position is sufficiently clear to conclude that proportionate consolidation involves recognising things as assets that are not assets.

Convergence

3.18 We understand from BC 24 of ED 9 that two of the reasons why the IASB believes the proposed amendments to IAS 31 benefit financial reporting are because they will improve comparability and will achieve convergence “in principle” with US GAAP. While it is difficult to come to firm conclusions in the absence of concrete examples, we have the following comments with regard to convergence with US GAAP:

(a) Under US GAAP, where a party to a joint arrangement holds an “undivided interest” in assets, is proportionately liable for each liability and there is no other separate legal entity, the parties to the venture would account for the assets, liabilities and results of operations on a “proportionate gross basis”, which is similar to the way joint assets are accounted for under ED 9. However, US GAAP provides an exception for undivided interests in real estate under joint control, which must be accounted for using the equity method.

(b) Under EITF Issue No. 00-1, investments in unincorporated legal entities must be accounted for by the equity method, except for investments in unincorporated oil- and gas-producing entities and unincorporated entities in the construction industry, for which venturers may continue to use proportionate consolidation (“equity method on a proportionate gross basis”) as this is an established practice in those industries. We believe that under

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Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [CON 6, paragraph 25; Footnote reference omitted.]

[4] Proposed Working Definition of an Asset

An asset is a present economic resource to which the entity has a present right or other privileged access.

a. *Present* means that both the economic resource and the right or other privileged access to it exist on the date of the financial statements.

b. An *economic resource* is something that has positive economic value. It is scarce and capable of being used to carry out economic activities such as production and exchange. It can contribute to producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources include unconditional contractual promises that others make to the entity, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. A *right or other privileged access* enables the entity to use the present economic resource directly or indirectly and precludes or limits its use by others. Rights are legally enforceable or enforceable by equivalent means (such as by a professional association). Other privileged access is not enforceable, but is otherwise protected by secrecy or other barriers to access.

ED 9 some unincorporated entities (such as partnerships) might well be determined to be joint assets, and thus accounted for differently from the general rule of EITF Issue No.00-1.

(c) US GAAP does not have a “rights and obligations” core principle. In the variant to illustrative example 2 in ED 9, under US GAAP, the equity method would be applied to the company holding the aircraft. The venturers’ interest in the company would be the advance made to the joint venture to finance the purchase of the aircraft (plus any other investment made). We do not believe that there would be a “right to use” asset recognised in the venturers’ books, nor would there be a “residual” joint venture entity representing the residual value of the aircraft, to be accounted for by the equity method.

3.19 If our understanding is correct, it follows from this that convergence will not be achieved in many instances. And, as the FASB has not yet determined whether it will adopt IAS 31 or its equivalent without any exceptions, such as those cited in EITF Issue No. 00-1, that will remain the case for some time. Bearing that in mind, we question whether the disruption that this proposed amendment will cause can be justified.

Do the proposals of ED 9 represent a short-term position?

3.20 The IASB and the FASB are currently undertaking a number of projects that seem likely to introduce the notion of a reporting entity and change the definition of assets and liabilities, the principles of asset and liability recognition, the principles of control and the consolidation of entities. While we understand that the IASB cannot cease its standard-setting activities until it finalises this work, we think it is important that changes to existing standards should not be undertaken if it is possible that those changes might need to be reversed (or if further changes might be necessary) because of changes to the underlying concepts and principles. That would be very disruptive.

3.21 In our view, the fact that US GAAP has (as explained in the previous section) had to allow exceptions to its general principle that proportionate consolidation should not be applied, and the fact that an approach that the IASB believes is more consistent with the Framework seems to result in less useful information (and therefore requires additional disclosure) are both signs that the Framework's concepts and guidelines in these areas might not yet be quite right. Bearing that in mind, we think that it would not be unreasonable to wait until the global discussion of the key concepts and principles underlying the proportionate consolidation debate is further advanced before proceeding with these proposals.

Other considerations

3.22 Elimination of proportionate consolidation means that there is a lack of differentiation between accounting for JVs and associates, whereas the degree of control is very different (joint control for the former and significant influence for the latter). Significant influence is frequently exercised over an associate by the investing entity’s having a representative on the associate’s board. Joint control is generally exercised in a way which requires much more involvement by the investor in the management of the joint venture, both at board level and often at the operational level. Some believe that these differing degrees of control should be reflected by a graduation of different accounting methods. We find the argument of BC 24 (that the equity method has been used to account for joint ventures in many parts of the world and that the equity method is outside the scope of the project) insufficient justification for taking the fundamental step of eliminating the proportionate consolidation option.

Questions 4–6 – Disclosure

The exposure draft proposes:

- ***to require an entity to describe the nature of operations it conducts through joint arrangements (see paragraph 36 of the draft IFRS and paragraph BC22 of the Basis for Conclusions).***
- ***to align the disclosures required for joint ventures with those required for associates in IAS 28 Investments in Associates (see paragraphs 39–41 of the draft IFRS and paragraph BC23 of the Basis for Conclusions).***
- ***to require the disclosure of summarised financial information for each individually material joint venture and in total for all other joint ventures (see paragraph 39(b) of the draft IFRS and paragraph BC13 of the Basis for Conclusions).***
- ***as consequential amendments to IAS 27 Consolidated and Separate Financial Statements and IAS 28, to require disclosure of a list and description of significant subsidiaries and associates. Those disclosure requirements were deleted in 2003 as part of the Improvements project. However, the Board understands from users that such disclosures are useful.***
- ***as a consequential amendment to IAS 28, to require disclosure of current and non-current assets and current and non-current liabilities of an entity's associates. The proposed IFRS would require disclosure of current and non-current amounts, whereas IAS 28 currently requires disclosure of total assets and total liabilities.***

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?

EFRAG's Response

4.1 As we have already explained, we do not believe it is appropriate at the current time to eliminate proportionate consolidation. However, in order to be as helpful as possible we have, for the purpose of responding to question 4, assumed that proportionate consolidation will nevertheless be eliminated.

4.2 When proportionate consolidation is used, all the detailed disclosures required for fully consolidated entities are also required for those proportionately consolidated entities, whereas the disclosures required in respect of entities incorporated by the equity method are very summary. The insights provided by the two different disclosure regimes are very different. We see a difference between the degree of involvement an entity has in the operation of a jointly-controlled entity and that which it has in an associate. As a result, although we believe the summarised disclosures proposed in ED 9 are appropriate for associates, we think the deeper involvement of reporting entities in the operations of their jointly-controlled entities requires, in our view, more detailed disclosures in order to help the user of the financial statements to understand the importance of these entities to the group.

4.3 If ED 9 were to become a final standard, we believe that the best way to compensate for the loss of aggregated information in the primary statements would be to adapt the presentation of the income statement and balance sheet to provide users with an indication of the financial elements included in the joint ventures. Presentation of such information on the face of the financial statements should be mandatory for all joint ventures incorporated using the equity method, but the choice of format should be free, thus leaving management to decide upon what it believes to be the most useful and relevant formats for the entity's circumstances. In Appendix 3 we provide a series of possible formats for such presentation which we commend to the IASB's attention. There are certainly other possible presentations. The requirement of IAS 1 to present entities accounted for under the equity method in a single line makes such presentation awkward, and we suggest that the IASB might reconsider this as part of its deliberations on ED 9.

4.4 In the absence of the modified primary statement formats discussed in paragraph 4.3, we think the proposed disclosures in respect of the joint ventures may not go far enough to compensate for the loss of proportionate consolidation as far as detail is concerned. Further breakdown of the balance sheet and income statement along the lines of the main financial statements would help users gain a fuller understanding of the scale, degree of control and risks of the reporting entity:

(a) Balance sheet: split of non-current assets between intangibles and property, plant and equipment; current assets split between inventories, receivables and other; other liabilities sub-divided to show provisions, finance debt and other.

(b) Income statement to show major lines: revenue; operating expenses; operating profit/loss; exceptional items (gain/loss on disposals); interest expense; tax.

Disclosures of this nature should be encouraged but not be mandatory.

4.5 We are aware that there are entities which create large joint ventures for individual contracts. As proposed new paragraph 39(b) requires details of the balance sheet and income statement of individually material joint ventures, that would mean that the client for the contract would be able to identify the margin the venturer is making on the contract. That seems to us to be commercially sensitive information. We recognise that this requirement is similar to the IFRS 8 requirement to disclose the existence of the major customers upon which the entity might depend, but IFRS 8 does not require identification of the customers or disclosure of the net profit generated by each of these customers. We think a requirement only to identify the major joint venture without details of its financial statements might satisfy the purpose of the disclosure whilst avoiding disclosing commercially sensitive information. In addition, it may be useful for the future standard to provide more guidance on how large an "individually material joint venture" should be to warrant separate disclosure.

4.6 In conformity with IAS 1, some financial institutions present their balance sheets based on liquidity rather than the current/non-current analysis. It may be useful to permit such entities to disclose the assets and liabilities of their joint ventures in a consistent manner.

4.7 Paragraph 38 specifically mentions that contingent liabilities are to be disclosed in accordance with IAS 37. We understand that it is necessary to set out in the revised standard the requirements of paragraphs 38(a) and (b) (because they are more detailed than the more general disclosure requirements of IAS 37), but we do not understand why the reference to IAS 37 is needed. If the purpose of this is to scope out from disclosure contingent liabilities where settlement is remote, then it would be more helpful to state the scope here rather than to refer to another IFRS.

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?

EFRAG's Response

5.1 Yes, we see this information as useful.

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?

EFRAG's Response

6.1 Yes, these disclosures are useful, but we believe that it would be more useful to provide more information than currently proposed, as discussed in our response to Question 4.

Other Comments

A possible way forward

7.1 For all of the above reasons we think it would be premature and perhaps even inappropriate to eliminate the option of proportionate consolidation from IAS 31 at the current time. On the other hand, we think an amendment that the IASB could make that might be helpful to users of financial statements would be to insert in IAS 31 a requirement for management to select the accounting method for jointly-controlled entities that best reflects the nature of its interest in each jointly-controlled entity taking into account the entity's circumstances and sector of activity and results in the most appropriate information (in other words, will be the most useful to users). The standard could perhaps include criteria such as, for example, whether the interest was in an operating activity or an investment, to direct management towards the most useful accounting method for each type of jointly-controlled entity, and could require management to justify its choice of method in its disclosures.

7.2 In addition, in BC13 the IASB describes one of the problems it sees with proportionate consolidation as being the fact that 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. We suggest that this could be resolved by eliminating the option in current IAS 31 which permits entities to aggregate proportionately consolidated assets and liabilities with those of controlled entities. The remaining required method would be for such items to be presented in separate but adjacent lines in the primary statements.

Drafting

7.3 In our view, the section of ED 9 entitled "Types of joint arrangement" requires an introduction to explain what the essence of a joint arrangement is, before introducing the three types of joint arrangement. In the proposals, the notion of shared decision making is not introduced until paragraph 7, even though it is fundamental to a joint arrangement. The definitions relevant to joint arrangements are located in appendices to the standard, as in some recent IFRSs, but it would be probably be more helpful here to discuss the characteristics of joint arrangements, such as shared decision making and joint control, additionally at the beginning of this section in order to facilitate the understanding of the different types of arrangement and the consequent accounting for them.

7.4 It is not clear what point paragraph 4 of ED 9 is making. We think it is saying that in respect of any one joint arrangement the three types of joint arrangement are not mutually exclusive. If this is correct then the wording could be amended to something like the following: "In respect of any one individual joint arrangement, a party to the arrangement may have interests in one or more of the different types of joint arrangement at the same time. Each of these has to be accounted for appropriately in accordance with this IFRS."

7.5 The flowchart illustration of Appendix B to ED 9 would be more helpful if the various "decision points" were linked the relevant paragraphs of the standard by cross-reference, as in IAS 39 paragraph AG 36 or IAS 37 Appendix B. This would allow preparers to understand what the principles or analysis involved at each stage are.

7.6 Certain disclosures have to be made in respect of joint ventures which are scoped out of ED 9 by paragraph 2. We feel there is a risk that these disclosure requirements might be overlooked because of their location in this section and believe that it would be clearer to include the disclosure requirements in a separate paragraph within the Scope section.

7.7 Paragraph 23 states that "A venturer shall recognise its interest in a joint venture using the equity method…" We think that the equity method is also a measurement method and that it may be useful to state this here, i.e. "…recognise and measure its interest…", or to use the words of IAS 28, i.e. "…account for its interest…using the equity method".

7.8 We believe that paragraph 23(c) of ED 9 is redundant as it contains the detail of paragraph 10 of IAS 27, which is referred to in paragraph 23(b) of ED 9.

7.9 The core principle of ED 9 is that "parties to a joint arrangement recognise their contractual rights and obligations arising from the arrangement". We think the IASB means "contractual rights and contractual obligations", but as its normal drafting style would be to include that second "contractual" there is some uncertainty in our minds. Therefore, if "contractual" relates to obligations, then this should be made clear.

7.10 As a final minor point on this section, we do not think that the inclusion of the reference to "a foreign country" adds anything useful to the example of a joint venture in paragraph 19.

APPENDIX 2
Examples of Possible Presentation of Joint Ventures in Income Statement and Balance Sheet under Equity Method

EXAMPLE 1 (UK FRS 9) — **CONSOLIDATED PROFIT AND LOSS ACCOUNT**

	2006			**2005**		
	Group CUmillions	**Share of Joint ventures** CUmillions	**Total** CUmillions	**Group** CUmillions	**Share of Joint ventures** CUmillions	**Total** CUmillions
Turnover:	200	120	320	200	120	320
Cost of sales	-120	-80	-200	-120	-80	-200
Gross profit	80	40	120	80	40	120
Administrative expenses	-40	-10	-50	-40	-10	-50
Operating profit	40	30	70	40	30	70
Gain/(loss) on disposals of fixed assets	0	0	0	0	0	0
Group share of net profit after tax in						
Joint ventures	15	-15	0	15	-15	0
Associates	10		10	10		10
	65	15	80	65	15	80
Interest receivable	6	0	6	6	0	6
Interest payable	-26	-10	-36	-26	-10	-36
Profit before tax	45	5	50	45	5	50
Tax	-5	-5	-10	-5	-5	-10
Net profit after tax	40	0	40	40	0	40

EXAMPLE 1 (UK FRS 9) — **CONSOLIDATED BALANCE SHEET**

	2006			**2005**		
	Group CUmillions	**Share of Joint ventures** CUmillions	**Total** CUmillions	**Group** CUmillions	**Share of Joint ventures** CUmillions	**Total** CUmillions
Non-current assets						
Intangible assets	80	20	100	80	20	100
Property, plant and equipment	400	80	480	400	80	480
Investments accounted for by the equity method						
Investments in joint ventures	50	-50	0	50	-50	0
Investments in associates	20		20	20		20
	550	50	600	550	50	600
Current assets						
Inventory	15	5	20	15	5	20
Trade and other receivables	75	23	98	75	23	98
Cash and cash equivalents	10	2	12	10	2	12
	100	30	130	100	30	130
Total assets	650	80	730	650	80	730
Current liabilities						
Trade and other payables	-40	-8	-48	-40	-8	-48
Current tax payable	-5	-2	-7	-5	-2	-7
Finance debt	-5		-5	-5		-5
	-50	-10	-60	-50	-10	-60
Non-current liabilities						
Provisions	-10	0	-10	-10	0	-10
Deferred tax	-50	-5	-55	-50	-5	-55
Finance debt	-200	-65	-265	-200	-65	-265
	-260	-70	-330	-260	-70	-330
Total liabilities	-310	-80	-390	-310	-80	-390
Net assets	340	0	340	340	0	340
Capital and reserves						
Equity holders of the parent	300			300		
Minority interest	40			40		
Shareholders' equity	340			340		

EXAMPLE 2 **CONSOLIDATED PROFIT AND LOSS ACCOUNT**

	2006		2004	
	CUmillions	CUmillions	CUmillions	CUmillions
Turnover:				
Group and share of joint ventures	320		320	
Less: Joint ventures	-120		-120	
Group turnover		200		200
Cost of sales				
Group and share of joint ventures	-200		-200	
Less: Joint ventures	80		80	
Group cost of sales		-120		-120
Gross profit		80		80
Administrative expenses				
Group and share of joint ventures	-50		-50	
Less: Joint ventures	10		10	
Group administrative expenses		-40		-40
Group operating profit		40		40
Gain/(loss) on disposals of fixed assets				
Group and share of joint ventures	0		0	
Less: Joint ventures	0		0	
Group Gain/(loss) on disposals		0		0
Group share of net profit after tax in				
Joint ventures		15		15
Associates		10		10
Interest receivable				
Group and share of joint ventures	6		6	
Less: Joint ventures	0		0	
Group interest receivable		6		6
Interest payable				
Group and share of joint ventures	-36		-36	
Less: Joint ventures	10		10	
Group interest payable		-26		-26
Profit before tax		45		45
Tax				
Group and share of joint ventures	-10		-10	
Less: Joint ventures	5		5	
Group tax on profit		-5		-5
Net profit after tax		40		40

EXAMPLE 2

CONSOLIDATED BALANCE SHEET

	2006		**2005**	
	CUmillions	CUmillions	CUmillions	CUmillions
Non-current assets				
Intangible assets				
Group and share of joint ventures	100		100	
Less: Joint ventures	-20		-20	
Group intangible assets		80		80
Property, plant and equipment				
Group and share of joint ventures	480		480	
Less: Joint ventures	-80		-80	
Group property, plant and equipment		400		400
Investments accounted for by the equity method				
Investments in joint ventures		50		50
Investments in associates		20		20
		550		550
Current assets				
Inventory				
Group and share of joint ventures	20		20	
Less: Joint ventures	-5		-5	
Group inventory		15		15
Trade and other receivables				
Group and share of joint ventures	98		98	
Less: Joint ventures	-23		-23	
Group trade and other receivables		75		75
Cash and cash equivalents				
Group and share of joint ventures	12		12	
Less: Joint ventures	-2		-2	
cash and cash equivalents		10		10
		100		100
Total assets		650		650
Current liabilities				
Trade and other payables				
Group and share of joint ventures	-48		-48	
Less: Joint ventures	8		8	
Group trade and other payables		-40		-40
Current tax payable				
Group and share of joint ventures	-7		-7	
Less: Joint ventures	2		2	
Group current tax payable		-5		-5
Finance debt				
Group and share of joint ventures	-5		-5	
Less: Joint ventures	0		0	
Group finance debt		-5		-5
		-50		-50
Non-current liabilities				
Provisions				
Group and share of joint ventures	-10		-10	
Less: Joint ventures	0		0	
Group provisions		-10		-10
Deferred tax				
Group and share of joint ventures	-55		-55	
Less: Joint ventures	5		5	
Group deferred tax		-50		-50
Finance debt				
Group and share of joint ventures	-265		-265	
Less: Joint ventures	65		65	
Group finance debt		-200		-200
		-260		-260
Total liabilities		-310		-310
Net assets		340		340

EXAMPLE 2(a) Alternative presentation **CONSOLIDATED BALANCE SHEET**

	2006		2005	
	CUmillions	CUmillions	CUmillions	CUmillions
Non-current assets				
Group intangible assets		80		80
Group property, plant and equipment		400		400
Investments accounted for by the equity method				
Net assets of joint ventures				
Intangible assets	20		20	
Property, plant and equipment	80		80	
Non-current assets	100		100	
Current assets	30		30	
Current liabilities	-10		-10	
Deferred tax	-5		-5	
Finance debt	-65		-65	
Non-current liabilities	-70		-70	
Investments in joint ventures		50		50
Investments in associates		20		20
		550		550
Current assets				
Group inventory		15		15
Group trade and other receivables		75		75
cash and cash equivalents		10		10
		100		100
Total assets		650		650
Current liabilities				
Group trade and other payables		-40		-40
Group current tax payable		-5		-5
Group finance debt		-5		-5
		-50		-50
Non-current liabilities				
Group provisions		-10		-10
Group deferred tax		-50		-50
Group finance debt		-200		-200
		-260		-260
Total liabilities		-310		-310
Net assets		340		340
Capital and reserves				
Equity holders of the parent		300		300
Minority interest		40		40
Shareholders' equity		340		340

EXAMPLE 3

CONSOLIDATED PROFIT AND LOSS ACCOUNT

	2006		**2005**	
	Equity method	**Proportionate consolidation**	**Equity method**	**Proportionate consolidation**
	CUmillions	CUmillions	CUmillions	CUmillions
Turnover:	200	320	200	320
Cost of sales	-120	-200	-120	-200
Gross profit	80	120	80	120
Administrative expenses	-40	-50	-40	-50
Operating profit	40	70	40	70
Gain/(loss) on disposals of fixed assets	0	0	0	0
Group share of net profit after tax in				
Joint ventures	15		15	
Associates	10	10	10	10
	65	80	65	80
Interest receivable	6	6	6	6
Interest payable	-26	-36	-26	-36
Profit before tax	45	50	45	50
Tax	-5	-10	-5	-10
Net profit after tax	40	40	40	40

EXAMPLE 3

CONSOLIDATED BALANCE SHEET

	2006		2005	
	Equity method	Proportionate consolidation	Equity method	Proportionate consolidation
	CUmillions	CUmillions	CUmillions	CUmillions
Non-current assets				
Intangible assets	80	100	80	100
Property, plant and equipment	400	480	400	480
Investments accounted for by the equity method				
Investments in joint ventures	50		50	
Investments in associates	20	20	20	20
	550	600	550	600
Current assets				
Inventory	15	20	15	20
Trade and other receivables	75	98	75	98
Cash and cash equivalents	10	12	10	12
	100	130	100	130
Total assets	650	730	650	730
Current liabilities				
Trade and other payables	-40	-48	-40	-48
Current tax payable	-5	-7	-5	-7
Finance debt	-5	-5	-5	-5
	-50	-60	-50	-60
Non-current liabilities				
Provisions	-10	-10	-10	-10
Deferred tax	-50	-55	-50	-55
Finance debt	-200	-265	-200	-265
	-260	-330	-260	-330
Total liabilities	-310	-390	-310	-390
Net assets	340	340	340	340
Capital and reserves				
Equity holders of the parent	300		300	
Minority interest	40		40	
Shareholders' equity	340		340	