THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

11 January 2008

Our ref: ICAEW Rep 06/08

Your ref:

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

By email to www.iasb.org - Open to comment page

Dear Sirs

ED 9 JOINT ARRANGEMENTS

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on Exposure Draft *ED 9 Joint Arrangements*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 06/08

ED 9 JOINT ARRANGEMENTS

Memorandum of comment submitted in January 2008 by The Institute of Chartered Accountants in England and Wales in response to the IASB exposure draft 'ED 9 Joint Arrangements', published in September 2007

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the International Accounting Standards Board (IASB) Exposure Draft of *'ED 9 Joint Arrangements*', published in September 2007.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.

3. Our members provide financial knowledge and g uidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Conceptual basis

4. While we agree in principle that a party to a joint arrangement should recognise its contractual rights and obligations in a joint arrangement irrespective of its legal form, we are concerned that the Board may not have fully explored the practical implications of its proposals. We believe that in practice it may be difficult to distinguish between a joint asset (an asset in which each party has rights) and an asset held in a joint venture (an asset which is subject to joint control).

5. Furthermore, we are concerned that the apparent requirement to split certain joint arrangements into an interest in joint assets and a residual interest in a joint venture will cause uncertainty for preparers in measuring the respective interests and raises issues about the unit of account that are yet to be deliberated in the context of the review of the Framework. We are also concerned about the application of the equity method where the interest in the residual joint venture is a net liability.

6. We believe that it is a serious weakness that the proposals do not address the accounting for the interest in the residual joint venture in the separate financial statements of the venturers.

Removal of proportionate consolidation

7. We agree that ideally accounting standards should not offer options of accounting treatment. However, we do not believe that the Board has developed an adequate argument as to why proportionate consolidation (rather than equity accounting) should be removed as an option in accounting for joint ventures. Moreover, we are concerned that the Board's rationale for

removing proportionate consolidation is based on definitions of assets and liabilities that have yet to be deliberated in the context of the review of the Framework. We therefore believe that it may be premature to prohibit proportionate consolidation pending consideration of this aspect of the Framework.

8. We do not necessarily object to the equity method as the only allowed treatment but we are concerned that the equity method may cause overstatement of the net assets of a venturer in a situation where a joint venture has net liabilities because the venturer's share of the net liabilities that would be recognised in proportionate consolidation may not be recognised under the equity method. We believe that this situation may be particularly prevalent in situations where a joint arrangement has to be split into an interest in joint assets and a residual interest in a joint venture (to which equity accounting would have to be applied).

Convergence with US GAAP

9. We are concerned that the Board has presented these proposals in the form of a short-term convergence project. We do not believe that differences in accounting for joint arrangements are the source of significant divergence between financial statements prepared in accordance with IFRS and US GAAP. Furthermore, we are not convinced that the proposals will actually achieve convergence with US GAAP.

10. According to paragraph BC24, US GAAP 'generally requires the use of the equity method to account for jointly controlled entities'. However, we are aware that proportionate consolidation is permitted under US GAAP where an entity is involved in either the construction industry or an extractive industry. Moreover, US literature does not appear to segregate joint operations, joint assets and joint ventures.

11. We believe that the proposed removal of the jointly controlled entity concept would actually introduce a new difference between IFRS and US GAAP and the Board's proposals would deny proportionate consolidation to an entity involved in the construction industry or an extractive industry that would be permitted to apply proportionate consolidation under US GAAP.

12. We therefore suggest that it in this respect it is inappropriate to converge with US GAAP which is itself in need of review. We would prefer that accounting for joint arrangements under both IFRS and US GAAP is redeliberated in the context of the revised Framework. If the Board proceeds with its current proposals we suggest that it should provide a more detailed exposition of where the proposals would bring about convergence with US GAAP (and where differences would remain).

Disclosure

13. We believe that the additional disclosures suggested by the Board are a step in the right direction as they serve to address (and therefore also appear to reconfirm) some of the weaknesses of the equity method. We suggest that additional information should be required about about dividends and about which assets included on the investor's balance sheet are joint assets.

Drafting

14. We found that the significance of some aspects of the proposals (in particular that a joint venture could be part of a joint arrangement) was not immediately apparent from the text and could only be properly understood by reference to the illustrative examples. Examples should illuminate principles as applied in specific circumstances and should not be used as a substitute for proper exposition.

Conclusions

15. We do not believe that the proposals should be implemented as a standard. We suggest that the exposure draft is taken no further for the time being and revisited once the concepts on which it is based have been properly deliberated in the context of the review of the Framework. We are concerned that the exposure draft leaves unanswered many questions relating to implementation in practice and do not believe that it will secure convergence with de facto US GAAP, which is one of its principal objectives.

16. We are not convinced that the claimed improvements warrant imposing this change on preparers in advance of a conclusion to the long-term project (which we accept could well be some time away).

17. If the IASB's objective (and the exposure draft would have benefited from a clearer explanation of its objectives) is to reduce optional treatments in the short term pending the result of a long-term project, then we believe a simpler (albeit still potentially controversial) solution would have been simply to remove the option for proportionate consolidation from IAS 31 and introduce the enhanced disclosures.

ANSWERS TO IASB QUESTIONS

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?**

18. We have some difficulty with the way joint arrangements are described in the exposure draft. We note that the three types of arrangement identified in the exposure draft are described rather than defined. Although we note that this is true of the existing standard, we see this as a deficiency that should be rectified.

19. We can see that the term 'jointly controlled entity' is no longer appropriate, because it may not be an entity. However, using the term 'joint ventures' is potentially confusing. Joint venture is often used as a generic term for all the

joint arrangements identified in the exposure draft, and the exposure draft (e.g., in the definition of 'joint control' and paragraph BC17) appears to use terms 'venture' and 'venturer' generically. The proposed terminology therefore does not improve clarity and may lead to confusion.

20. Paragraph 5 describes a joint venture in terms of 'the outcome of a group of assets and liabilities carrying on an economic activity', which suggests that economic activity is integral to a joint venture. Paragraph 18 describes a business in terms of 'assets and resources working together to form an outcome'. The relationship between a business and economic activity is not clear but the implication is that business is a subset of economic activity. We do not see the point of the distinction, nor why the exposure draft does not simply refer to a business instead of economic activity (which is not defined). Similarly, the distinction between an operation and a business needs to be clarified. We suggest that the term business, which is defined in IFRS 3, should be used throughout.

21. There are a number of difficulties arising from the revised definition of joint control. Paragraph BC 17 explains the change in focus in the definition of a joint arrangement from joint control to shared decision-making. While we do not necessarily disagree with this, the paragraph goes on to state that 'Venturers do not often establish financial and operating policies for a joint operation or joint asset arrangement'. We suggest that venturers would often establish detailed policies for a joint operation.

22. In changing the focus from joint control to shared decision-making, the exposure draft appears to have lost the idea that it is the 'strategic' financial and operating policies that are important. With the 'strategic' limiter having disappeared from the definition of joint control, it would appear that *all* the financial and operating policies have to be 'governed', so materiality considerations are not relevant. As set out in the existing Basis of Conclusions to IFRS 3 (BC21), 'requiring unanimous consent on all financial and operating decisions would narrow by too far the types of arrangements meeting the definition of a joint venture'. It is for this reason that the Board decided not to remove the word 'strategic' from the existing IAS 31 joint control definition as part of the ED 3 project. We do not believe that the changes to the focus and definitions proposed by the exposure draft justify extending the 'power to govern' requirement to all financial and operating decisions.

23. The definition of joint control in IAS 31 makes it clear that unanimous decision-making is required to qualify as a joint venture. The need for unanimity of decision-making is not clearly stated in the new definitions in the exposure draft. The need for unanimity must be deduced by combining the new definitions of 'shared decisions' and 'party to a joint arrangement'. We believe that this adds ambiguity and the exposure draft should refer specifically to consensus decision-making.

24. If the proposals remain unchanged in this respect, we suggest that additional guidance should be given on when, and if so how, 'deadlock' mechanisms and the role of the veto should be taken into account in determining whether or not there is shared decision-making over a joint arrangement.

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 (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.**

(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?**

25. While we agree in principle that a party to a joint arrangement should recognise its contractual rights and obligations relating to the arrangement irrespective of its legal form, we are not co nvinced that the Board has not fully explored the practical and conceptual implications of its proposals.

26. In particular, we are concerned about the apparent requirement in certain circumstances to split a joint arrangement into both an interest in joint assets and an interest in a joint venture. While this approach differs from the current standard this is not brought out explicitly in the exposure draft. While paragraph 15 hints at this in stating "A joint venture is an arrangement, *or part of a joint arrangement*, that is jointly controlled by the venturers", the significance of the words we have italicised is apparent only in the Illustrative Examples.

27. Consider Illustrative Example 2 in which the parties to a joint arrangement have the rights of use to an aircraft and also interests in a company that has legal ownership of the aircraft. Paragraph IE16 explains that in this scenario the parties would recognise their rights to use the aircraft (a joint asset) and would additionally recognise their interests in the company using the equity method (a joint venture).

28. We are concerned that in practice it may be difficult to distinguish between a joint asset (an asset in which each party has rights) and an asset held in a joint venture (an asset which is subject to joint control).

29. Furthermore, in explaining Illustrative Example 2, paragraph IE16 goes on to state that the aircraft recognised by the company will have been affected by the contractual allocation of rights of use to the parties and that the company would therefore recognise an aircraft asset that excludes the rights of use transferred to the parties. Traditionally, the venturers would recognise their share of the cost of the joint asset but the example suggests that the venturers should recognise (and the company derecognise) an intangible right of access to the joint asset. Without explanation of this approach in the

text of the draft standard, we do not understand how preparers would determine the part of the aircraft asset that is to be derecognised by the company. Under existing applicable IFRSs, one might conclude that the company has leased the aircraft to the individual parties under an operating lease arrangement. In short, we acknowledge that the draft standard proposes a look-through approach to the investee's accounts, but as we do not currently look through the 'corporate veil' under IFRS, we struggle to articulate its principles and are uncertain regarding how it might be applied in practice. We are concerned that the proposals precede the Board's deliberations on the unit of account that are to be conducted in the context of the review of the Framework.

30. We are not convinced that the Board has considered the effect of the proposals in the context of equity accounting when applied to net liabilities and are concerned that the proposed accounting may cause the net assets of venturers to be overstated. With reference to Illustrative Example 2, as the aircraft is recognised as a joint asset, it is likely that the residual that is to be recognised as a joint venture will be a net liability. In equity accounting, a net liability is not recognised unless the venturer has an obligation to meet the liabilities. Accordingly, under the proposals the venturer may not recognise a liability that would be recognised under the existing standard whereby the company would be equity accounted for (or proportionately consolidated) as a jointly controlled entity.

31. We understand that the proposals would not extend the use of equity accounting to joint ventures in the separate financial statements of the venturers. We presume that a venturer would be required to recognise its share of joint assets in its separate financial statements. We are unclear how (without use of equity accounting) the venturer should account for its residual interest in the joint venture in its separate financial statements.

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?**

32. We agree that, ideally, accounting standards should not offer options of accounting treatment. However, we do not believe that the Board has developed an adequate argument as to why proportionate consolidation (rather than equity accounting) should be removed as an option in accounting for joint ventures.

33. Paragraphs BC8 et seq state that proportionate consolidation is inconsistent with the Framework and leads to recognition as assets and liabilities of a proportion of items that the party to a joint venture does not control or for which it has no obligation. However, the Framework is under review and an important phase of the review will deal with the definition of assets and liabilities. We believe that it may be premature to prohibit proportionate consolidation pending consideration of this aspect of the Framework. Moreover, we are concerned that while the Board has criticised proportionate consolidation it has done nothing to explain why equity accounting is superior. Indeed, paragraph BC 14 states that 'consideration of the equity method, and any alternative to it, is outside the scope of this short-term project'.

34. We do not necessarily object to the equity method as the only allowed treatment as it reflects the fact that the party to the arrangement has an investment rather than a share in the individual assets and liabilities. Furthermore, IFRS do not generally apply a 'look-through' approach, and we can see that it that it might be inappropriate to lift the corporate veil to achieve proportionate consolidation.

35. However, we see a potential problem with the equity method in relation to net liabilities. Whereas these would be reflected on line-by-line proportionate consolidation, there would have to be a legal or constructive obligation before the amount recognised under the equity method could fall below zero. We fear that liabilities (primarily financial liabilities) could therefore be excluded from the balance sheet where there is considered to be no legal or constructive obligation. We therefore suggest that there should be disclosure of net liabilities not recognised under the equity method.

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?**

36. We agree that the note disclosure is an improvement and goes some way to addressing the weaknesses of the equity method. However, the disclosures are principally related to joint ventures, and there is no required disclosure of joint assets which we believe would assist users of financial statements.

37. We note that paragraph 39(b) requires certain information to be disclosed for individual material joint ventures, but paragraph C8, in amending paragraph IAS 28 *Investments in Associates* requires only information 'in total for all

associates'. We believe that the disaggregated information is useful and should be provided in respect of associates to the extent that it is available to the investor.

***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?**

38. Yes. It may also be helpful to users if an entity were to be required to provide a list and description of significant joint ventures that are entities and provide information on significant joint ventures that are not entities.

***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?**

39. Yes. We request that more prominence is given to the disclosure of dividends received and receivable from joint ventures in order to provide information about cash flows.

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