EFRAG

European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 20 March 2013 to Commentletters@efrag.org

XX April 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft Acquisition of an Interest in a Joint Operation

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Acquisition of an Interest in a Joint Operation (Proposed amendment to IFRS 11)* issued by the IASB on 13 December 2012 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

The ED provides guidance on accounting for the acquisition of an interest in a joint operation whose activity is a business as defined in IFRS 3 *Business Combinations*. The IASB proposes to amend IFRS 11 so that a joint operator should apply the relevant principles for business combinations accounting in IFRS 3 and other relevant IFRSs when accounting for such acquisitions. Neither IFRS 11 *Joint Arrangements* nor IAS 31 *Interests in Joint Ventures* explicitly address this type of transaction.

EFRAG agrees that diversity in practice exists on how joint operators account for the acquisition of an interest in a jointly controlled operation, particularly when the activity of the jointly controlled operation under IAS 31 constitutes a business, as defined in IFRS 3. This diversity is likely to continue given that IFRS 11 (which superseded IAS 31) does not address accounting for the acquisition of a joint operation. Therefore, EFRAG supports the IASB's efforts to address the issue.

EFRAG agrees with the IASB's proposal on the basis that it addresses current diversity in practice on how to account for acquisitions of interests in a joint operation whose activity constitutes a business.

However, EFRAG is concerned that considerable judgement is required in practice to distinguish a joint operation from a joint venture. Requiring the application of the principles on business combinations accounting would put considerable stress on how the definition of a 'joint operation' and a 'business' is understood by preparers and auditors.

EFRAG notes that acquisitions of interests in joint operations might often involve (i) contributions of assets, businesses or (parts of) subsidiaries, (ii) loss of control over those, and/or (iii) increasing the joint operator interest in the joint operation.

The ED does not specifically address the accounting for the loss of control over a business that is contributed to a joint operation, in exchange for an interest in that joint operation, nor the acquisition of an additional interest in the same joint operation. We believe that these types of transactions should be addressed comprehensively to avoid new uncertainty and diversity in practice.

Furthermore, EFRAG is also concerned that the ED leaves open a number of cross-cutting issues all related to the different aspects of the transactions referred to above. In this respect, we recommend the IASB to further explore the interaction of the ED with existing requirements in IFRSs and other amendments currently being developed by the IASB.

Our detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista, Anna Vidal or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

Appendix

Notes to constituents

1 *The objective of the ED is to introduce guidance in IFRS 11* Joint Arrangements *on how a joint operator should account for the acquisition of an interest in a joint operation in which the activity of the joint operation constitutes a business, as defined in IFRS 3* Business Combinations.

2 *Specifically, the amendments propose that a joint operator should apply the relevant principles for business combinations accounting in IFRS 3 and other IFRSs, which include:*

(a) *Measuring identifiable assets and liabilities at fair value with the exceptions given in IFRS 3 and other IFRSs;*

(b) *Recognising acquisition-related costs as expenses when incurred and the services are received, with the exception that the costs to issue debt or equity securities are recognised in accordance with IAS 32* Financial Instruments: Presentation *and IFRS 9 Financial Instruments;*

(c) *Recognising deferred tax assets and liabilities arising from the initial recognition of assets or liabilities, except for deferred tax liabilities arising from the initial recognition of goodwill; and*

(d) *Recognising the excess of the considered transferred over the net identifiable assets acquired and the liabilities assumed, if any, as goodwill.*

3 *The joint operator should also disclose the relevant information required by those IFRSs for business combinations when accounting for such acquisitions.*

4 *Under IFRS 11, a joint arrangement is classified as either a joint venture or a joint operation. A joint operator recognises in its financial statements its share of the assets, liabilities, revenue and expenses that arise from the joint operation. However, IFRS 11 (which superseded IAS 31* Interests in Joint Ventures) *does not provide guidance on how to account for an acquisition of an interest in a joint operation.*

5 *The ED focuses on the accounting from the point of view of the joint operator rather than the accounting in the financial statements of the joint operation. In this respect, the joint operator would apply the amendments in accounting for the acquisition of an interest in an existing joint operation – in which the activity constitutes a business – but also to the acquisition of an interest in a joint operation on its formation – when there is an existing business. The proposed amendment should not be applied if the formation of the joint operation coincides with the formation of the business.*

6 *As noted in paragraph BC1 of the ED, the IFRS Interpretation Committee reported to the IASB that practice differed significantly in accounting for the acquisition of interests in jointly controlled operations or assets, as specified in IAS 31, including the formation of those when existing businesses are contributed in the formations. Paragraph BC10 further explains that the ED is a narrow scope project limited to those fact patterns that are subject so significant diversity in practice.*

7 *Entities would be required to apply the ED prospectively, mainly to avoid the use of hindsight in determining the acquisition-date fair values.*

8 *In addition, the IASB proposes a consequential amendment to paragraph C5 of IFRS 1* First-time Adoption of International Financial Reporting Standards *so that the transition relief for business combinations that occurred before the date of transition to IFRSs also applies to acquisitions of interests in joint operations that are businesses.*

EFRAG's responses to the questions raised in the Exposure Draft

Question 1: relevant principles

The IASB proposes to amend IFRS 11 and IFRS 1 so that a joint operator accounting for the acquisition of an interest in a joint operation in which the activity of the joint operation constitutes a business applies the relevant principles on business combinations accounting in IFRS 3 and other Standards, and discloses the relevant information required by those Standards for business combinations.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response

EFRAG supports the IASB's proposal on the basis that it addresses current diversity in practice.

However, we are concerned that considerable judgement is required in practice to distinguish a joint operation from a joint venture.

9 EFRAG supports the ED on the basis that it addresses current diversity in practice. We believe that the lack of control over the joint operation should not preclude the application of the principles in IFRS 3.

10 We agree with the rationale in paragraph BC7 of the ED which explains that the separate recognition of goodwill, when present, is preferable compared to allocating premiums to identifiable assets acquired on the basis of relative fair values. Applying the relevant principles for business combinations in IFRS 3 and other IFRSs would provide a comprehensive set of accounting principles which, in turn, would ensure a consistent accounting treatment for all transactions relating to the acquisition of an interest in a joint operation whose activity constitutes a business.

11 Furthermore, users of financial statements have indicated to EFRAG that they prefer to recognise goodwill separately, when it is present, in the acquisition of a joint operation even if the joint operator was not obtaining control. In addition, they stressed that it was important to account for transactions that involved businesses in the same way.

12 IFRS 11 requires a joint operator to recognise assets, liabilities, revenue and expenses according to its share in the assets, liabilities, revenues and expenses of the joint operation as determined and specified in the contractual arrangement, rather than base its recognition on the ownership interest that it has in the joint operation. In EFRAG's view, this accounting should not preclude the application of the principles in IFRS 3 to acquisitions of interests in joint operations, when the investor pays a premium for the interest in the joint operation whose activity constitutes a business. In addition, we note that the exclusion of transactions in the ED where no existing business is contributed to the joint operation on its

formation, is consistent with the fact that in such a case no premium (goodwill) on the fair value of the net assets is paid.

13 In respect of the application of the principles in IFRS 3, EFRAG also notes that IAS 28 *Investments in Associates and Joint Ventures* indicates in paragraph 26 that the principles underlying the procedures used in accounting for the acquisition of a subsidiary should be used for such acquisitions of associates and joint ventures.

14 In order to ensure that the standards developed by the IASB are sufficiently clear to all those who use or rely on these standards, EFRAG believes that the IASB should not only propose a consequential amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* but also to IFRS 3 to indicate that business combinations accounting might also apply to acquisitions of interests in joint operations.

15 Under IFRS 11, the unit of account of a joint arrangement is the activity that two or more parties have agreed to control jointly. When assessing classification of the joint arrangement, a party assesses its rights to the assets and obligations for the liabilities relating to that activity, which could be a business. EFRAG agrees with the ED to require the activity of the (whole) joint operation to be a business, rather than the acquired *interest* in a joint operation to be a business.

16 We note that the distinction between a joint operation and a joint venture requires exercise of judgement and might not necessarily be easy to apply given the complex interaction between the definition of a joint operation and that of a business in IFRS 3. Although paragraph BC29 of IFRS 11 states that a 'business' can be found in all types of joint arrangement (i.e. joint ventures and joint operations), the existing definition of a 'business' in IFRS 3 suggests that only few joint operations might be in fact businesses.

17 Although it is difficult to assess at this stage whether the ED would affect many joint operators (as IFRS 11 is only effective from 1 January 2013), EFRAG is concerned that significant consequences of requiring the application of the principles on business combinations accounting would now come to depend on – and possibly drive the interpretation of – the untested notion of 'joint operation'. The IASB might end up exchanging one type of divergence in practice for another type of inconsistent application.

18 In particular, the requirement to recognise significant amounts of deferred tax liabilities (and corresponding goodwill) on a business combination might come to dominate the underlying accounting analysis. However, significant consequences might also result from other differences between the principles set out in IFRS 3 and the acquisition of assets, such as:

(a) Treatment of acquisition costs, since those costs should be expensed in business combinations, but should be capitalised for asset acquisitions;

(b) Recognition of goodwill, which is only recognised in case of business combinations;

(c) Treatment of purchase consideration paid in shares, since IFRS 3 provides guidance in the case of business combinations, but IFRS 2 *Share-based Payment* applies to all other types of transactions; and

(d) Treatment of contingent consideration, which is only defined by IFRS 3 but which is undefined for asset acquisitions.

19 In addition, EFRAG is concerned that the IASB is addressing on a piecemeal basis a cross-cutting issue that affects (1) asset purchases, (2) businesses combinations and (3) transactions involving subsidiaries. The ED addresses diversity in practice by moving the dividing line that separates transactions accounted for as business combinations from those that are accounted for as asset purchases, but does not remove or justify the need for that distinction.

20 In this respect, we refer here to EFRAG's [draft] comment letter on the IASB's Exposure Draft *Annual Improvements to IFRSs 2011 – 2013 Cycle* where we recommend that the IASB should consider in a comprehensive way the accounting consequences of the distinction between acquisitions of assets and business combinations, rather than as part of a series of separate standard setting initiatives, which in addition to the ED currently include the following:

(a) IASB projects on:

(i) Accounting for Contingent Consideration in a Business Combination within the Annual Improvements to IFRSs 2010 – 2012 Cycle;

(ii) Scope of application of IFRS 3 and IAS 40 *Investment Property*, which this annual improvement ED addresses; and

(iii) Sales or contributions of assets between an investor and its associate/ joint venture (Proposed amendments to IFRS 10 and IAS 28);

(b) IFRS Interpretations Committee projects on:

(i) IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IFRIC 12 *Service Concession Arrangements* – Variable payments for the separate acquisition of PPE and intangible assets.

21 The main reason for the recommendation above is that although amendments to IFRSs related to this distinction might be fairly insignificant in its own right, they point at more substantive unaddressed issues resulting from the significant differences as identified above.

Question 2: scope

The IASB intends to apply the proposed amendment to IFRS 11 and the proposed consequential amendment to IFRS 1 to the acquisition of an interest in a joint operation on its formation. However, it should not apply if no existing business is contributed to the joint operation on its formation.

Do you agree with the proposed amendment? Why or why not? If not, what alternative do you propose?

EFRAG's response

EFRAG agrees that the ED (including the proposed consequential amendment to IFRS 1) should be applied to the acquisition of an interest in a joint operation on its formation. However, EFRAG is concerned that the ED does not comprehensively address the issues and may give rise to new issues.

22 EFRAG agrees that the ED (including the proposed consequential amendment to IFRS 1) should be applied to the acquisition of an interest in a joint operation on its formation – when an existing business is contributed – on the basis that diversity has been observed in accounting practices in relation to this type of transaction. However, EFRAG has a number of concerns that are explained below.

Accounting for the loss of control over a business that is contributed to a joint operation in exchange for an interest in that joint operation

23 When an entity becomes a joint operator by contributing an existing business to a joint operation upon its formation, that transaction falls within the scope of the ED in accordance with paragraph B33B of the ED. The requirements of IFRS 10 regarding a loss of control would only apply if the entity contributed a subsidiary holding the business, but not if the entity contributed a business outright. This provided that the requirements of paragraph B34 of IFRS 11 or other guidance would not apply in the accounting for these contributions as explained in paragraph 27 below.

24 The ED does not explicitly address accounting for the loss of control over a business that is not a subsidiary, when such a business is contributed upon formation of a joint operation. Furthermore, the same issue would arise upon similar acquisitions of interests in existing joint operations that are businesses, whereby an entity becomes a joint operator. Absent further clarification, diversity in practice may continue to exist. Therefore, EFRAG believes that these types of transactions should be addressed comprehensively by the IASB.

25 Finally, we also refer here to the IASB's Exposure Draft *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (proposed amendment to IFRS 10 and IAS 28) in which the IASB intends to resolve the conflict between IFRS 10 *Consolidated Financial Statements* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Ventures* (currently included in IAS 28 (2011) *Investments in Associates and Joint Ventures*). In that project, the IASB proposes that a sale or contribution of a business (an asset or a subsidiary) to an associate or joint venture should be accounted for by applying the principles in IFRS 10 (i.e. to recognise a full gain in the transaction); however, sales or contributions to joint operations are excluded from its scope.

Accounting for the acquisition of an additional interest in the same joint operation

26 The ED does not specifically address the accounting required when an investor acquires an additional interest in a joint operation, while maintaining joint control. The ED implies that the joint operator should apply IFRS 3 to the acquisition of further interests. While this is consistent with the application of the equity method, a key principle underlying IFRS 3 is that it is applied only once at the date of the business combination. Therefore, we believe that the IASB should make clear how a joint operator should account for acquisitions of additional interests in a joint operation after it already obtained joint control and why that treatment is appropriate.

Cross-cutting issues

27 EFRAG is further concerned that the narrow scope of the ED leaves open a number of cross-cutting issues all of them related to different aspects of transactions that involve (1) the acquisition of interests in joint operations, (2) contributions of assets, businesses or (parts of) subsidiaries and/or (3) loss of

control over subsidiaries. In particular, EFRAG notes that the scope of following requirements in IFRSs may potentially overlap:

(a) Paragraph B34 of IFRS 11 – When an entity enters into a transaction with a joint operation in which it is a joint operator, such as a sale or contribution of assets, this paragraph requires the joint operator to recognise gains and losses resulting from such a transaction only to the extent of the other parties' interest in the joint operation.

EFRAG notes regarding the acquisitions of an interest in a joint operation by way of a contribution, that uncertainty exists about whether or not the requirements of IFRS 10 override paragraph B34 of IFRS 11. In addition, we note that it is not entirely clear whether or not paragraph B34 only applies to joint operations in which an entity is *already* a joint operator and whether or not it also applies to contributions of businesses.

(b) Paragraph 38 of IFRS 3 – This paragraph – which may need to be applied by analogy – prohibits a remeasurement of assets and liabilities to their acquisition-date fair value, if they are transferred as consideration to the combined entity and are therefore under the control of the acquirer before and after the business combination.

(c) Paragraph 25 and B98 of IFRS 10 – If an entity loses control of a subsidiary, this paragraph indicates that it should derecognise the assets and liabilities of that subsidiary, recognise any investment retained at its fair value at the date when control is lost while requiring full profit or loss recognition of any resulting gain.

IFRS 10 requires any retained interest that is directly held by the former parent to be remeasured at fair value, which might be inconsistent with the measurement of interests contributed to a joint operation if paragraph B34 in IFRS 11 was applicable.

(d) Paragraph 31A of IAS 28 as proposed by the IASB's Exposure Draft *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture* (proposed amendment to IFRS 10 and IAS 28) – According to the proposed paragraph, the gain or loss resulting from the sale or contribution of assets that constitute a business, as defined in IFRS 3, between an investor (including its consolidated subsidiaries) and its associate or joint venture is recognised in full in the investor's financial statements (i.e. the investor's interest in the gains or losses resulting from these transactions is not eliminated).

28 EFRAG believes that the IASB should further explore the interaction of the ED with the requirements above to avoid that unresolved cross-cutting issues lead to diversity in practice.

Question 3: transition requirement

The IASB intends to apply the proposed amendment to IFRS 11 and the proposed consequential amendment to IFRS 1 prospectively to acquisitions of interests in joint operations in which the activity of the joint operation constitutes a business on or after the effective date.

Do you agree with the proposed transition requirement? Why or why not? If not, what alternative do you propose?

EFRAG's response

We agree with the proposed transition requirement to apply the ED and the consequential amendment to IFRS 1 prospectively.

29 Even though entities might have the required information to apply the proposed requirements retrospectively – for example, when such information was obtained at the time of the initial accounting as a basis for recognising the transaction under a different accounting approach or for other purposes – we agree that not all the acquisition-date fair values of the identifiable assets and liabilities that would have to be recognised as part of the transaction in accordance with the business combinations guidance in IFRS 3 and other IFRSs might be available. At the same time, entities might face significant challenges in obtaining the information required for retrospective application. Therefore, we agree that prospective application of the ED would avoid the use of hindsight and thus enhance the financial reporting of companies involved in such acquisitions.

30 We also support the IASB's proposal to permit earlier application of the ED provided that entities disclose this fact.