EFRAG

European Financial Reporting Advisory Group

17 April 2013

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

Dear Sir/Madam,

Re: Exposure Draft ED/2012/7 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 ED/2012/7 *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 an 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.

EFRAG supports the objective of the ED and the IASB's efforts to address the diversity in practice that might arise as neither IFRS 11 *Joint Arrangements* nor IAS 31 *Interests in Joint Ventures* provide guidance on accounting for an acquisition of an interest in a joint operation. However, as discussed in the Appendix to this letter, we have identified several significant concerns with the application of the principles in IFRS 3 to acquisitions of interests in joint operations, which we believe may lead to new diversity in practice. We do not believe that resolving divergence in practice by moving to another source of diversity is an appropriate solution to resolving the issue the ED addresses.

We note that the essence of IFRS 11 is to reflect the rights and obligations that a joint operator has in a joint arrangement that is classified as a joint operation. Unlike IAS 31, IFRS 11 does not permit proportionate consolidation, and therefore it is less obvious why a joint operator would apply the principles in IFRS 3 to an acquisition of an interest in a joint operation, regardless of whether the activity of the joint operation would, in itself constitute a business.

Regarding the scope of the ED, we note that an interest in a joint operation can be acquired in various ways – for example (i) without transfer of equity interest (ii) through a sale or contribution of assets, businesses or (parts of) subsidiaries in exchange for an interest in a joint operation, (iii) loss of control over those, and/or (iv) increasing the joint operator interest in the joint operation. However, the ED focuses on a narrow set of circumstances and fails to address acquisition of an interest in a joint operation in a comprehensive manner. This will potentially lead to new diversity in practice.

The narrow scope of the ED also raises a number of cross cutting issues, including:

(a) Interaction between paragraph B34 and IFRS 11, involving a sale or contribution of assets by an entity to a joint operation in which it is a joint operator.

(b) Application of paragraph 38 of IFRS 3 regarding acquiring a business combination by way of a contribution of assets as consideration for the acquisition.

(c) Interaction with paragraph 25 and B98 of IFRS 10 which requires remeasurement to fair value of any interest retained in a former *subsidiary*, with any resulting gain or loss recognised in 'full' in profit and loss.

(d) Interaction with paragraph 31A of Amendments to IAS 28 in ED/2012/06, which addresses sales or contributions of assets by an entity to a joint venture or an associate, and requires recognition of a 'full' gain or loss *when* the item sold or contributed, constitutes a *business*.

For the reasons explained above, we do not agree with the proposed amendments.

In our view, to achieve consistent accounting for acquisitions of joint operations and related transactions, a more comprehensive analysis of accounting for acquisitions of an *interest* in a joint operation is required. Furthermore, we believe the IASB needs to further explore the interaction of the ED with the existing requirements in IFRSs and other amendments currently being developed by the IASB, rather than finalising the amendments in their current form.

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

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 objective of the ED to address diversity in practice. However, we have a number of significant concerns with the application of the principles in IFRS 3 to acquisition of interests in a joint operation. We therefore do not support the proposed amendments.

1 EFRAG supports the objective of the ED to address the diversity in practice that might arise as neither IFRS 11 nor IAS 31 provide guidance on the accounting by a joint operator for the acquisition of an interest in a joint operation.

2 However, we would like to caution that differences in accounting treatment that merely reflect differences in the substance of the underlying interest acquired should not be mistaken for true diversity in practice, where similar transactions are treated differently.

3 As explained below, we have identified significant concerns with the proposals, which may lead to new diversity in practice. We do not believe that resolving divergence in practice by moving to another source of diversity is an appropriate solution. For this reason, we do not agree with the proposed amendments.

4 To achieve consistent accounting for acquisitions of joint operations and related transactions, we believe that a more comprehensive analysis of an 'acquisition accounting model' for interests in joint operations is needed.

Recognition of goodwill

5 We support 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. 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 in interest in a joint operation even if the joint operator was not obtaining control, and stressed that it was important to account for transactions that involved businesses in the same way.

6 We also agree 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.

7 In respect of the application of the principles in IFRS 3 *Business Combinations*, EFRAG 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.

8 However, we note that IFRS 11 defines a joint operation to be a joint arrangement whereby the parties that have joint control of the arrangement (i.e. joint operators) have rights to the assets, and obligations for the liabilities, relating to the interest they have in the arrangement. Therefore, the essence of IFRS 11 is to reflect those rights and obligations that joint operators have as a result of their interests in the arrangement. This is different to accounting for a business combination and also different to accounting for an investment in an associate or a joint venture, regardless of whether the joint operation is a business.

9 In our view, there is an important distinction to make between accounting for a transaction involving an acquisition of "rights to assets and obligations for liabilities", and a transaction involving a business combination as defined in IFRS 3. We regard the former as being more akin to an acquisition of "assets", rather than an acquisition of a business.

Does an interest in a joint operation constitute a business?

10 We agree with paragraph BC29 of IFRS 11, that states that a 'business' can be found in all types of joint arrangements (i.e. joint ventures and joint operations). However, we believe 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).

11 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, as explained in the ED, could be a business. We do not disagree that this could be the case.

12 However, we emphasise that the essence of IFRS 11 is to reflect the rights and obligations that a joint operator has in a joint arrangement. Unlike IAS 31, IFRS 11 does not permit proportionate consolidation, and therefore it is less obvious why a joint operator would apply the principles in IFRS 3 to an acquisition of an interest in a joint operation, particularly because IFRS 3 is based on the entity concept whereas a joint operation is by definition not part of the entity.

13 Therefore, regardless of whether the activity of a joint operation meets the definition of a business, we are not convinced that an *interest* in a joint operation – which is based on the recognition of rights and obligations - can meet that definition. One could argue that if the interest being acquired is classified as a joint operation, an entity has concluded that that individual interest does not in itself constitute a business. We note that IFRSs provide limited guidance on the meaning and application of the term "interest", and it is only IFRS 12 *Disclosure of Interests in Other Entities* that provides a definition of "interest".

14 A key issue in practice has been the definition of a business under IFRS 3. The proposed amendments will require an entity to determine whether the activity of a joint operation meets the definition of a business under IFRS 3. As also explained in our response to the recent ED 2012/6 *Sale or Contribution of Assets between an Investor and its Associate or Joint Venture*, applying the definition of a business in IFRS 3 is not always straightforward and often requires considerable judgement. The amendments do not provide additional guidance on what constitutes a

"business" in the context of a joint operation. This might lead to new diversity in practice.

15 Furthermore, we note that the distinction between a joint operation and a joint venture also requires a high degree 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.This difficulty affects both the consolidated financial statements and the separate financial statements, given that the accounting for joint operations is the same in both sets of accounts. We note that the difficulties in determining whether an activity constitutes a business have been evidenced by the ongoing work by the IFRS Interpretations Committee on the issue.

16 We are 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. In particular, significant consequences might also result from the 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.

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

(e) Recognition of deferred tax under IAS 12 *Income Taxes*. 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. Furthermore, we believe there is a certain logic to recognising deferred tax in a business combination as there is usually at least one legal entity which is being acquired, and that legal entity has its own tax personality and historical tax cost. In the case of investments in joint operations there will often not be any legal entity involved, and therefore the application of the requirement in IAS 12 will not necessarily be the same as in the case of a business combination.

Addressing issues on a piecemeal basis

17 In our view, the ED tries to address 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.

18 We are concerned that the IASB is addressing on a piecemeal basis a number of issues relating to the application of IFRS 3, distinguishing an acquisition of assets from a business and other related cross-cutting issues affecting other IFRSs. In this respect, we refer here to EFRAG's 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 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.

19 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.

Consequential amendments to other IFRSs

20 We have identified the following consequential amendments that the IASB should consider if it decides to go ahead with the ED:

(a) *Amendments to IFRS 3* – 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.

(b) *Inconsistency with IAS 12* – Paragraphs 15 and 24 of IAS 12 (initial recognition exemption) refer only to business combinations, and not to acquisitions of interests in joint operations. If the IASB moves to finalise this amendment they should also make a consequential amendment to IAS 12 to make it clear that deferred tax is recognised when an investment is made in a joint operation that is a business.

(c) *Interaction with scope of IAS 39* – IAS 39 paragraph 2(g) excludes contracts for business combinations from the scope of IAS 39 such that those contracts are not accounted for as derivatives in the period between signing binding agreements and completion. The proposed amendment states that the acquisition of an interest in a joint operation should be accounted for similarly to a business combination. The IASB would need to consider a consequential amendment to IAS 39 paragraph 2(g) to also scope-out acquisitions of joint operations from derivative accounting.

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 is concerned that the ED does not comprehensively address a number of related issues and may give rise to new uncertainty and diversity.

21 EFRAG agrees that the proposed amendments and the consequential amendment to IFRS 1 should not apply if no existing business is contributed to the joint operation on its formation. This is consistent with the observation that in this case no premium (goodwill) on the fair value of the net assets is paid or contributed by the joint operator.

22 There are various ways in which an investor can acquire an interest in a joint operation. However, the ED does not consider this, as it focuses on a narrow set of circumstances. In our view, this may result in new uncertainty and diversity in practice.

23 Our detailed concerns 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

24 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. This is based on the assumption that the requirements of paragraph B34 of IFRS 11 or other guidance would not apply in the accounting for these subsidiary contributions as explained in paragraph 31 below.

25 The ED does not explicitly address the accounting for 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.

26 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.

Acquisition of an interest in a joint operation without the transfer of equity interests

27 We note that an interest in a joint operation can also be acquired without the transfer of equity interests. For example, an 'acquirer' can obtain joint control of an entity that was previously accounted for as an associate, due to changes in the contractual agreements with the (formerly) controlling entity. In such a case, no 'equity interests' are transferred.

28 It is our understanding that paragraphs 43 and 44 of IFRS 3 (which address business combinations achieved without the transfer of consideration) would apply by analogy to this situation. However, clarification of this point would be helpful.

Acquisition of a joint operation on its formation

29 An investor might acquire an interest in a newly founded joint operation in which, based on the contractual terms of the arrangement, the parties to the joint operation would keep their own assets and liabilities. We are not certain whether the ED would apply to this type of acquisition; and if the ED did apply, we question which of the principles in IFRS 3 should be applied and specifically, whether the same assets and liabilities that belonged and continue to belong to the joint operators should be remeasured to fair value.

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

30 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 in the same joint operation. 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

31 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) sale or contributions of assets, businesses or (parts of) subsidiaries in exchange for an interest in a joint operation and/or (3) loss of control over subsidiaries that have been sold or contributed. 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 sale or 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 sale or 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).

32 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 that the ED and the consequential amendment to IFRS 1 should be applied prospectively.

33 Should the IASB decide to go ahead with the ED, we agree that the proposed amendment to IFRS 11 and the proposed consequential amendment to IFRS 1 should apply prospectively.

34 In our view, even though entities might have the required information to apply the proposed requirements retrospectively, entities might be faced with some challenges to apply the principles in IFRS 3 to that available information. We are concerned that the costs involved to overcome these challenges might outweigh the benefits of retrospective application. Therefore, we agree with prospective application of the ED.

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