

IFRS 11: Joint Ventures – Transition from Proportionate Consolidation to the Equity Method

Extract, IFRS Discussion Group Report on Meeting – October 18, 2012

The classification of joint arrangements required by IFRS 11 *Joint Arrangements* depends upon the parties' rights and obligations arising from the arrangement in the normal course of business. When an entity has rights to the net assets of the arrangement, the arrangement is a joint venture. In accordance with paragraph 24 of IFRS 11, a joint venturer recognizes its interest in a joint venture as an investment and accounts for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*, unless IAS 28 exempts the entity from applying the equity method. Accordingly, IFRS 11 eliminates proportionate consolidation as a basis of accounting for interests in joint ventures.

Adoption of IFRS 11 requires modified retrospective application. In June 2012, the IASB issued amendments to the standard to provide relief from the presentation or restatement of comparative information for periods prior to the immediately preceding period. As outlined in paragraph C2 of amended IFRS 11, when changing from proportionate consolidation to the equity method, an entity recognizes its investment in the joint venture as at the beginning of the immediately preceding period. Paragraph C6 indicates that, after initial recognition of the equity method investment (i.e., subsequent to January 1, 2012 for an entity with a calendar year-end), an entity accounts for its investment in the joint venture using the equity method in accordance with IAS 28, thereby requiring restatement of the immediately preceding period.

Accordingly, entities may need to consider a number of consequential effects when adopting IFRS 11, particularly when changing from proportionate consolidation to the equity method. The Group considered the potential recognition and measurement differences and how such differences would be adjusted for on the application of IFRS 11 for the following six issues:

- Limits on the recognition of losses of the joint venture.
- Assessment of indicators of impairment rather than annual impairment testing.
- Full reversal of impairment losses, as there is no attribution of impairment to any underlying goodwill in respect of the joint venture.
- Capitalization of borrowing costs in the accounts of the investor.
- Discontinuance of hedge accounting.
- Reperformance of goodwill impairment testing.

The Group's Discussion

Group members noted that the first four issues are relatively straightforward, whereas issues five and six raise more conceptual issues about the transitional guidance.

Issue 1: Limits on the recognition of losses of the joint venture

Group members noted that a measurement difference may arise upon transition from proportionate consolidation to the equity method under IFRS 11 when losses in excess of the carrying amount of the entity's interest in the joint venture had been recognized previously. Group members observed that paragraph C4 of IFRS 11 provides specific guidance for when a negative carrying amount should be recognized as a liability or adjusted to retained earnings at the beginning of the immediately preceding period.

Issue 2: Assessment of indicators of impairment rather than annual impairment testing

Group members noted that the timing and methodology for impairment assessment of an investment under the equity method may differ from annual impairment testing performed on goodwill that was separately recognized under proportionate consolidation. IAS 39 *Financial Instruments: Recognition and Measurement*, applicable to investments accounted for by the equity method, and IAS 36 *Impairment of Assets*, applicable to goodwill reported separately under proportionate consolidation, use different impairment indicators. Group members observed that paragraph C3 of IFRS 11 provides specific guidance on assessing whether the investment is impaired on the adoption of IFRS 11 and the treatment of any resulting impairment loss.

Issue 3: Full reversal of impairment losses as there is no attribution of impairment to any underlying goodwill in respect of the joint venture

An impairment loss related to goodwill recorded under proportionate consolidation would not be reversed. IAS 36 does not permit the reversal of a write-down of goodwill. On the other hand, an impairment loss recognized under the equity method may reverse to the extent that the recoverable amount of the investment subsequently increases. Group members observed that paragraphs C2 and C3 of IFRS 11 do not permit the reversal of goodwill impairments recorded prior to the determination of the opening balance (i.e., prior to January 1, 2012). However, an entity may need to assess whether an impairment loss recognized on or after January 1, 2012 no longer exists or has decreased.

Issue 4: Capitalization of borrowing costs in the accounts of the investor

Group members noted that borrowing costs that were capitalized under proportionate consolidation may not be eligible for capitalization under the equity method, in particular when the investor borrows the funds, but makes a capital injection, rather than a loan, to the joint venture. Group members observed that paragraphs C2 and BC61 of IFRS 11 suggest that the initial investment would not be adjusted for borrowing costs capitalized in the carrying amount of property, plant and equipment of the joint venture. However, any borrowing costs previously capitalized in the comparative period, which are no longer eligible for capitalization, would need to be reversed.

Issue 5: Discontinuance of hedge accounting

Group members noted that a joint venturer applying proportionate consolidation to a joint venture interest may have been able to apply hedge accounting to a specific risk exposure in the joint venture. In contrast, when a joint venture is equity accounted for, an investor cannot hedge its indirect risk in its exposure because paragraph 84 of IAS 39 does not permit hedging of an overall net position.

Group members observed that upon initial application of the equity method on adoption of IFRS 11, an entity will need to discontinue hedge accounting because the underlying item being hedged will no longer be proportionately consolidated into an entity's accounts.

The Group's discussion focused on how the discontinuance of hedge accounting upon transition from proportionate consolidation to the equity method should be reflected by the investor:

View A – Recognize the adjustment to retained earnings at the beginning of the immediately preceding period (and, accordingly, derecognize the effects of hedge accounting in the comparative period).

View B – Apply the change retrospectively in accordance with paragraph 19 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

View C – Apply the guidance in IAS 39 with respect to the discontinuance of hedge accounting upon transition and:

- *recognize the effect of the hedge in profit or loss when the hedged item will affect the results of the joint venture; or*
- *recognize the effect of the hedge in profit or loss immediately at the date of transition (i.e., in the first interim period of the preceding period).*

Group members had a robust debate, with individual members expressing support for each of the various views and identifying a few additional approaches. Throughout the discussion, Group members raised several interesting questions, including when the termination of the hedged item occurs.

Group members emphasized that the discussion was trying to deal only with the cumulative effects of hedge accounting during the period the investment was proportionately consolidated. The Group discussed various aspects of this issue, including which standard applies, what to do with the cumulative effect of hedge accounting, and what ordering should occur in applying the various relevant aspects of IFRSs.

Group members observed that IFRS 11 does not address any consequential adjustments that an entity may have to make beyond those made to the assets and liabilities of the joint venture that are directly affected by the transition from proportionate consolidation to the equity method. In light of the diversity of views expressed, Group members observed that entities facing this issue should think about the complexities involved in their specific fact pattern and consult with their advisors before making any decisions about appropriate accounting treatments.

Issue 6: Reperformance of goodwill impairment testing

Group members considered circumstances in which the goodwill associated with a joint venture that previously was allocated to a larger cash-generating unit or group of cash-generating units for goodwill impairment testing. Group members observed that, upon transition from proportionate consolidation to the equity method, the goodwill previously allocated to a group of cash-generating units should be reallocated to the joint venture and the other cash-generating unit(s) to which it belonged on the basis of their relative carrying amounts in accordance with paragraph C2 of IFRS 11.

Following this reallocation, the remaining goodwill balance will be supported solely by the cash flows of the remaining cash-generating unit(s). This may result in an issue if, for example, the joint venture generated disproportionately higher cash flows relative to its share of the carrying amount of goodwill.

Group members discussed the reperformance of goodwill impairment testing as a result of the goodwill associated with the joint venture being previously allocated to a larger cash-generating unit or group of cash-generating units. Specifically, Group members considered two questions:

1. Does the change in the level of testing driven by the transition from proportionate consolidation to the equity method require reperformance of the goodwill impairment test by the venturer for the goodwill that is allocated to the remaining cash-generating unit(s) and, if so, at what date(s)?

Group members noted that if there were indicators of impairment as at January 1, 2012, it would seem reasonable that an impairment test of the remaining cash-generating unit(s) would be tested. Group members noted that the transition provisions of IFRS 11 provide for a modified retrospective application requiring an entity to reperform the goodwill impairment at the beginning of the immediately preceding period (similar to View A in Issue 5). Group members observed that paragraph BC61 of IFRS 11 explains that, in response to concerns expressed about undue cost and effort of applying the requirements retrospectively, the IASB decided instead to require aggregating the carrying amounts of the assets and liabilities into a single line item. The IASB's recent amendments to the transitional provisions make it clear that the intent was to provide relief from full retrospective application by not requiring restatement of any additional comparative periods before the immediately preceding period.

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2. When the above-noted impairment test is completed as at the beginning of the immediately preceding period presented or earlier, how should any resulting impairment loss be reflected in the accounts on adoption of IFRS 11?

Group members noted that the specific guidance on the determination of the equity method investment appears to support that any additional impairment could be adjusted through opening retained earnings (similar to View A in Issue 5).

Overall Comments

Group members noted that this agenda item discussed the unique transitional relief in IFRS 11 that is specific to an entity moving from proportionate consolidation to the equity method. Group members cautioned that these unique transition provisions cannot be applied by analogy to other circumstances, such as moving from non-consolidation to consolidation. Similarly, the views expressed about hedge accounting and impairment are unique to the specific circumstances discussed and the same views would not necessarily apply under different circumstances.

Group members suggested that preparers should start thinking about their 2012 comparative figures when moving from proportionate consolidation to the equity method for periods beginning on or after January 1, 2013. Preparers should track any differences so they will be in a position to present comparative financial statements that appropriately reflect the necessary adjustments. Group members encouraged preparers to give some thought to the final two issues for which there is a lack of clear guidance on their treatment on adoption of IFRS 11, to gain an early understanding of the significance of the amounts involved and consult appropriately.