IFRS 11: Accounting for Changes in Classification between Joint Ventures and Joint Operations

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IFRS 11 Joint Arrangements and IAS 28 *Investments in Associates and Joint Ventures* are silent on how to account for a change in the contractual terms of a joint arrangement that results in a change in its classification (i.e., from a joint operation to a joint venture or vice versa). Such changes in classification may have "knock-on" accounting effects, including on other comprehensive income, the capitalization of borrowing costs, the use of hedge accounting, and impairment timing and measurement.

Fact Pattern:

Scenario 1 – Joint Operation to Joint Venture.

Entity A and Entity B, two unrelated parties, enter into a joint arrangement that is structured through a separate vehicle, Entity C. Entities A and B are obligated to purchase all of the output produced by Entity C. Based on an analysis of the facts and circumstances related to the arrangement in accordance with paragraphs B29-B33 of IFRS 11, the arrangement is classified as a joint operation. Therefore, both entities recognize their share of the assets, liabilities, revenues and expenses in accordance with paragraph 20 of IFRS 11.

After operating for a substantial period of time under the original contractual arrangement, Entities A and B determine that the production capability of Entity C is well in excess of original expectations and there is a high demand for the product. Entities A and B decide to amend the terms of the contractual arrangement so that they are no longer obligated to purchase all of the output but, instead, the joint arrangement could sell unlimited amounts of the output to third parties. After the change in the contractual arrangement, the parties each continue to have joint control and the same level of ownership interest in the arrangement.

Paragraph 19 of IFRS 11 requires that if facts and circumstances change, an entity shall reassess whether the type of joint arrangement in which it is involved has changed. Based on the fact pattern above, Entity C is now classified as a joint venture because the activities of Entity C can no longer be said to be primarily designed for the provision of output to the Entities A or B and there are no other facts and circumstances that indicate that Entity C is a joint operation after this amendment.

In this scenario, no other changes were made to the contractual arrangement that would trigger a change in the classification of the joint arrangement (for example, a change to the legal form, relevant activities, etc.). In circumstances when such changes were made, judgment would be required to determine the appropriate accounting. These other circumstances are not considered in this fact pattern.

Issue: How should the change in the classification of Entity C from a joint operation to a joint venture be accounted for in the financial statements of Entity A and Entity B?

The change in classification from a joint operation to a joint venture is as a result of new facts and circumstances. Therefore, under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, the change in classification would be treated like a change in accounting estimate and the new accounting applied prospectively. The Group considered whether this change triggers a remeasurement of the investment to fair value.

View A – The change in the classification of the joint arrangement does not trigger a fair value remeasurement.

While the contractual terms related to the interest held in Entity C have changed, the relationship between the entities and the joint arrangement is unchanged (i.e., the relationship is one of joint control before and after the change and the percentage ownership interest held by the parties before and after the transaction is also unchanged). This is different from a situation involving the acquisition or loss of control, which would trigger a change in the measurement basis.

Entities A and B should account for this change at cost, which is equal to the carrying amount of the investment at the date of the amendment. Paragraph 10 of IAS 28 requires that, under the equity method, "on initial recognition the investment in an associate or joint venture is recognized at cost." In the case at hand, cost could be considered to be the carrying amount of the pro-rata share of assets and liabilities immediately prior to the contract amendment because there was no increase or decrease in the invested amount in the joint arrangement as a result of this contractual change. Since the change in classification is a result of new facts and circumstances, the change should be made prospectively. Support for carrying value treatment can also be found by analogizing to the transitional guidance in Appendix C of IFRS 11.

This view of not remeasuring the investment is also consistent with the following:

- The principles of a common control transaction whereby a common control transaction is often measured at its carrying amount on the basis that there is no change in control over the assets. In the case at hand, there is no change in ownership interests and joint control is retained by each joint operator before and after the contract amendment. Recognition of a gain or loss due to a change in the contractual agreement would be the equivalent of permitting a revaluation of the assets and liabilities in the joint arrangement due to events solely within the control of the joint operators.

- Paragraph 24 of IAS 28, which requires no remeasurement when an associate becomes a joint venture and vice versa, even though such a change arguably has more economic significance (going from significant influence to joint control) than the change considered in the fact pattern at hand.

View B1 – The change in the classification of the joint arrangement triggers a fair value remeasurement.

The change in the classification of the joint arrangement is similar to a remeasurement event. While the parties have the same ownership interest and a joint control relationship before and after the change, the change results in an interest that is fundamentally different in its nature and required to be accounted for using the equity method after the contract amendment. That is, the change can be considered to be similar to the "disposal" of an interest in the assets and liabilities of a joint operation, followed by the "acquisition" of an interest in a joint venture. Paragraphs BC28 and BC 30 of IAS 28, regarding discontinuance of the use of the equity method, provide some relevant guidance on this point.

View B2 – The change in classification of the joint arrangement triggers a fair value remeasurement only if the joint arrangement is a business.

Remeasurement of the investment received is consistent with the IASB's tentative decision, in its 2012 Exposure Draft, "Sale or Contribution of Assets between an Investor and its Associate or Joint Venture," that if a subsidiary has been contributed to a joint venture or associate in exchange for an equity interest in that joint venture or associate, and that subsidiary qualifies as a business, a full gain or loss is recognized on the contribution. When this guidance is applied by analogy, and the joint arrangement qualifies as a business, then each entity is giving up its proportionate interest in the assets and liabilities of the joint operation in exchange for an equity interest in the joint venture. That supports remeasurement of the investment received at its fair value and recognition of a full gain or loss in profit or loss. In contrast, if the assets contributed to the joint venture do not constitute a business, the gain or loss on contribution is recognized only to the extent of the interest of any unrelated investors in the joint venture (i.e., the portion of the gain recognized by the entity making the contribution is eliminated).

View C – Remeasurement to fair value is an accounting policy choice.

In the absence of IFRS guidance specifically addressing the issue, and the conflicts that arise from analogy to different pieces of existing (and proposed) guidance, entities have an accounting policy choice to remeasure to fair value or not. The accounting policy selected should be applied consistently to all similar transactions involving a change in classification from a joint operation to a joint venture.

The Group's Discussion

Group members supported View A, that the change in classification from a joint operation to a joint venture does not trigger a fair value remeasurement, because the commercial substance of the arrangement has not changed. However, although they thought the technical arguments for View A were stronger, some Group members thought View B2 could not be ruled out completely.

One Group member observed that there are no known examples to date of View B being followed in Canada. Another Group member noted the impracticality, for many entities, of performing a fair value remeasurement, and suggested that the practicalities of View A aligned well with its conceptual merit.

The Group did not recommend any further action be taken on this issue at this time.

Scenario 2 – Joint Venture to Joint Operation.

The reverse occurs for the same reasons (i.e., a change in the contractual arrangement now obligates the joint operators to purchase substantially all the output of the joint arrangement).

Issue: How should the change in the classification of Entity C from a joint venture to a joint operation be accounted for in the financial statements of Entity A and Entity B?

In this scenario, Entities A and B will be required to derecognize the net investment in Entity C that was accounted for using the equity method and recognize their share of assets and liabilities in relation to the joint operation at the date the change in classification occurs.

The Group considered how the entities should measure their share of the assets and liabilities relating to the joint arrangement at the date of the reclassification event.

View A – The change in the classification of the joint arrangement does not trigger a fair value remeasurement.

View B1– The change in the classification of the joint arrangement triggers a fair value remeasurement.

View B2 – The change in the classification of the joint arrangement triggers a fair value remeasurement only if the joint arrangement is a business.

View C – Entities have an accounting policy choice between View A and View B (for the same reasons as in View C for Scenario 1).

The Group's Discussion

Group members' views on Scenario 2 (joint venture to joint operation) were the same as for Scenario 1 (joint operation to joint venture) for the same reasons. As with Scenario 1, the Group did not recommend any further action be taken on this issue at this time.