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Topic Gateways are intended as a refresher or introduction to topics of interest to CIMA members. They include a basic definition, a brief overview and a fuller explanation of practical application. Finally they signpost some further resources for detailed understanding and research.

Topic Gateways are available electronically to CIMA members only in the CPD Centre on the CIMA website, along with a number of electronic resources.

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CIMA supports its members and students with its Technical Information Service (TIS) for their work and CPD needs.

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CIMA members and students should sign into My CIMA to access these services and resources.

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Group accounting for joint ventures

Definition and concept

A joint venture is defined in International Accounting Standards (IAS) as:

‘A contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.’

*IAS 31, Interests in Joint Ventures*, paragraph three

IAS 31 prescribes two methods of accounting for joint ventures:

1. The equity method.
2. The proportional consolidation method.

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have agreed a ‘roadmap for convergence’ of international standards and US Generally Accepted Accounting Principles (GAAP). This ‘roadmap’ sets out the milestones that the FASB and the IASB have agreed to achieve in order to demonstrate standard-setting convergence.

This convergence is one part of the process towards removing the requirement imposed on foreign registrants by the US Securities and Exchange Commission (SEC) to reconcile their financial statements to US GAAP. For more information on this ‘roadmap’ please see:

www.iasb.org/Current+Projects/Memorandum+of+Understanding+with+the+FASB.htm

As part of the convergence process, the FASB and the IASB have agreed to identify short-term convergence opportunities. They have also agreed to look at their respective standards with a view to identifying major differences and they have issued statements to this effect. As they identify these differences, one or both of the boards issue proposals in the form of consultations to remove them by amending their standards. This is an ongoing process.

The US standard that addresses the accounting for joint ventures is APB 18, known as the equity method of accounting for investments in common stock. APB 18 requires that the equity method is used to account for joint ventures.

In December 2005, the IASB agreed to consider the accounting for interests in joint ventures within the short-term convergence project. This topic gateway describes the developments to date and the likely changes to the financial reporting principles for joint ventures under IFRS.
Context

In the current syllabus, CIMA students will learn and may be examined on this topic in paper P8, Financial Analysis.

Overview

Historically, investments in companies that did not qualify to be classified as subsidiaries were carried at cost. Income from these investments was only recognised when dividends were received. By the 1960s, there was a growing tendency for companies to conduct part of their activities by taking substantial minority stakes in other businesses. They exercised a degree of control over these businesses which fell short of complete control.

This trend led to a need for an intermediate form of accounting which would be somewhere between ‘accounting for at cost’ and ‘full scale consolidation.’

Companies such as Royal Dutch Shell used a modified form of consolidation. Here the investor’s share of the investee’s net assets was included in one line in the investor’s consolidated balance sheet. The share of its results was included at only some levels of the investor’s profit and loss account.

Other entities preferred to use another form of intermediate consolidation, known as proportionate consolidation. This involved bringing in the results, assets and liabilities of an investment on a line-by-line basis, but only to the extent of the investor’s share.

UK GAAP (FRS 9) and IFRS (IAS 31) have for some time permitted the use of these two methods of accounting for joint ventures. However, it is likely that the equity method will soon become mandatory because of the convergence programme between IFRS and US GAAP.

In practice

Accounting for joint ventures in practice

IFRS currently permits two methods of accounting for joint ventures:

Proportionate consolidation

This is currently the benchmark treatment under IFRS. Proportionate consolidation should be carried out either on an aggregated line-by-line basis or as separate items.
Where an aggregated line-by-line basis is used, the venturer includes its share of the assets, liabilities, income and expenditure of the entity within the corresponding items in its own consolidated accounts.

Where separate items are used, the venturer includes separate line items for its share of the total assets, liabilities, income and expenditure of the entity in its own consolidated accounts. For example, the line item ‘creditors’ would contain a sub-heading ‘share of creditors of joint ventures’.

**Equity method**

Under this method, the investment is initially recorded at cost. The carrying amount is increased or decreased to recognise the investor’s share of profits or losses of the investee after the acquisition date. Distributions received from the investee entity reduce the carrying amount of the investment.

IAS 31 permits the use of equity accounting but does not recommend it. This is because, in the IASB’s opinion, proportionate consolidation better reflects the substance and economic reality.

**Illustration of equity and proportionate consolidation**

This section contains a simplified illustration of the impact on consolidated results of equity reporting and proportionate consolidation of interests in jointly controlled ventures.

The investor or parent company, V Co, owns 50% of JV Co, the joint venture. Exhibit A presents individual company financial statements for V Co and JV Co. Exhibit B illustrates the equity method and proportionate consolidation impact on the consolidated balance sheet and income statements.
### Exhibit A: Individual Company Financial Statements

#### Balance Sheets

**December 31, 2006**

<table>
<thead>
<tr>
<th></th>
<th>V Co</th>
<th>JV Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Current Assets</td>
<td>100</td>
<td>16</td>
</tr>
<tr>
<td>Investment in JV Co at cost</td>
<td>6</td>
<td>-</td>
</tr>
<tr>
<td>Current Assets</td>
<td>34</td>
<td>12</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>140</strong></td>
<td><strong>28</strong></td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>(5)</td>
<td>(2)</td>
</tr>
<tr>
<td>Non-current Liabilities</td>
<td>(25)</td>
<td>(6)</td>
</tr>
<tr>
<td><strong>Net Assets</strong></td>
<td><strong>110</strong></td>
<td><strong>20</strong></td>
</tr>
<tr>
<td>Shareholders’ Equity b/fwd</td>
<td>70</td>
<td>12</td>
</tr>
<tr>
<td>Net income for the Year</td>
<td>40</td>
<td>8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>110</strong></td>
<td><strong>20</strong></td>
</tr>
</tbody>
</table>

#### Income Statements

**For the Year ended December 31, 2006**

<table>
<thead>
<tr>
<th></th>
<th>V Co</th>
<th>JV Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>120</td>
<td>30</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(60)</td>
<td>(16)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(20)</td>
<td>(6)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>40</strong></td>
<td><strong>8</strong></td>
</tr>
</tbody>
</table>

### Exhibit B: Equity Method and Proportionate Consolidation

#### V Co

**Consolidated Balance sheet**

**December 31, 2006**

<table>
<thead>
<tr>
<th></th>
<th>Equity</th>
<th>Proportionate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Current Assets</td>
<td>100</td>
<td>108</td>
</tr>
<tr>
<td>Investment in JV Co at cost</td>
<td>10</td>
<td>-</td>
</tr>
<tr>
<td>Current Assets</td>
<td>34</td>
<td>46</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>144</strong></td>
<td><strong>154</strong></td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>(5)</td>
<td>(6)</td>
</tr>
<tr>
<td>Non-current Liabilities</td>
<td>(25)</td>
<td>(28)</td>
</tr>
<tr>
<td><strong>Net Assets</strong></td>
<td><strong>114</strong></td>
<td><strong>120</strong></td>
</tr>
<tr>
<td>Shareholders’ Equity b/fwd</td>
<td>70</td>
<td>76</td>
</tr>
<tr>
<td>Net income for the Year</td>
<td>40</td>
<td>44</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>114</strong></td>
<td><strong>120</strong></td>
</tr>
</tbody>
</table>

#### Income Statements

**For the Year ended December 31, 2006**

<table>
<thead>
<tr>
<th></th>
<th>V Co</th>
<th>JV Co</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>120</td>
<td>135</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(60)</td>
<td>(68)</td>
</tr>
<tr>
<td>Share of profit of JV</td>
<td>4</td>
<td>(23)</td>
</tr>
<tr>
<td>Other expenses</td>
<td>(20)</td>
<td>(23)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td><strong>44</strong></td>
<td><strong>44</strong></td>
</tr>
</tbody>
</table>
Alternative treatments

In December 2005, the IASB agreed to consider accounting for interests in joint ventures within the short-term convergence project. The Board discussed the two alternative treatments in IAS 31 described above. It decided to limit the scope of the project to the two following issues:

1. To address the major difference between IAS 31 and APB 18 i.e. the option to use proportionate consolidation to account for joint ventures.

2. To consider the existing definition of a joint venture and the differences between a joint venture entity and direct interests in underlying assets and liabilities of a joint arrangement.

Differences between IFRS principles and US GAAP

There are a number of other differences between IFRS principles and US GAAP in relation to the accounting for joint ventures. However, these were not considered major enough to be included in the short-term convergence project. These differences are:

Exception to the scope of application

IAS 31 includes three exceptions to the requirement to apply either the equity method or proportionate consolidation. The circumstances underlying these exceptions are not addressed in US GAAP.

Requirement to conform accounting policies

This difference occurs where the joint venture uses different accounting policies to those of the venturer for like transactions. Here the IFRS requires that the venturer conforms the joint venture’s accounting policies to the venturers for the purposes of preparing group accounts. This is not required under US GAAP.

Differences in reporting date

IFRS requires that the reporting date of the joint venture be no more than three months from the reporting date of the venturer. However, this is only when it is impracticable to have the same reporting date. APB 18 does not prescribe a specific time limit, except to state that the time difference should be consistent from period to period.
Excess of joint venture’s share of losses over a venturer’s interest

If the equity method is applied, both standards require the venturer to discontinue recognising its share of further losses when:

- they equal or exceed its interest in the joint venture
- the investor has no legal or constructive responsibility for the shortfall.

However, the way ‘interest’ is defined is not exactly the same.

Presentation of extraordinary gains or losses

APB 18 requires extraordinary items to be classified separately unless they are immaterial. The concept of extraordinary items does not exist within IFRS.

Disclosure

The detailed disclosure requirements of IAS 31 and APB 18 differ. Generally, IAS 31 requires more disclosure.

Further details are available on these differences from the IASB. Please refer to the Joint Ventures page within the Current Projects section on the IASB website.

In March 2006, the IASB discussed papers on the definition of a joint venture. These were prepared by Australian Accounting Standards Board staff, who led a long-term research project on joint ventures. The board decided that the accounting by investors in a joint arrangement should be the contractual rights and obligations attached to their investment, not the particular form of arrangement.

It was decided to suspend the research project, pending the outcome of the short-term convergence project and other projects. These included the consolidation and conceptual framework projects.

Further work was undertaken by the IASB staff who proposed that interests that venturers have in a joint arrangement should be classified as either:

Direct interests. These relate to the underlying assets and liabilities. Venturers have rights to individual assets or direct obligations to individual liabilities, or to a share of them, within the group.

Indirect interests. These relate to the net common outcome expected to be generated from a group of underlying assets and liabilities under the joint control of all of the venturers.
The following two part proposal was put to the board in July 2006 and agreed:

1. A venturer would recognise its direct interests in single assets and liabilities in accordance with applicable standards.

2. A venturer would recognise its indirect interest in a joint venture using the equity method.

The project’s main objective is to converge US GAAP and IFRS by removing proportionate consolidation. Some IFRS preparers currently make use of the option to consolidate proportionately their joint ventures. The IASB decided that they would hold discussions with preparers to assess better the likely practical effects of this proposal. These meetings took place in October and November 2006. The IASB consulted preparers from the extractive, real estate, pharmaceutical, branded goods and insurance industries.

The IASB found that proposals regarding direct and indirect interests are expected to have little effect for ventures involving jointly controlled assets and operations. Preparers with direct interests in jointly controlled entities using the proportionate consolidation method would need to account for their direct interests in the individual assets and liabilities of the entity. This change in accounting method is not expected to change significantly the amounts recognised.

In September 2007 the IASB issued ED 9 Joint Arrangements. The most significant changes proposed are:

• to shift the focus in accounting for joint arrangements away from the legal form of the arrangements and onto the contractual rights and obligations agreed by the parties; and

• to remove the choice currently available for accounting for jointly controlled entities (equity method or proportionate consolidation) by requiring parties to recognise both the individual assets to which they have rights and the liabilities for which they are responsible, even if the joint arrangement operates in a separate legal entity. If the parties only have a right to a share of the outcome of the activities, their net interest in the arrangement would be recognised using the equity method.
The types of joint arrangement recognised by the ED are:

<table>
<thead>
<tr>
<th>Type</th>
<th>Characteristics</th>
<th>Ownership of assets</th>
<th>Summary of accounting required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint operation</td>
<td>Involves the use of the assets and other resources of the parties, often to manufacture and sell a joint product.</td>
<td>Each party generally owns its own assets that it uses to create the joint product.</td>
<td>Recognise controlled assets and incurred liabilities, expenses incurred and share of revenues and expenses from the sale of goods or services by the joint arrangement.</td>
</tr>
<tr>
<td>Joint asset</td>
<td>Each party takes a share of the output from the asset and bears an agreed share of the costs incurred to operate the asset.</td>
<td>Each party has rights, and often has joint ownership of the assets used to generate the output.</td>
<td>Recognise share of joint assets, classified according to the nature of the asset, liabilities incurred (including those jointly incurred), revenue from the sale of share of output and expenses incurred.</td>
</tr>
<tr>
<td>Joint venture</td>
<td>Joint arrangement that is jointly controlled by the venturers. Each venturer is entitled to a share of the outcome of the activities of the joint venture.</td>
<td>Venturers do not have rights to individual assets or obligations for expenses of the venture.</td>
<td>Recognise the interest in the joint venture using the equity method unless an exemption applies (held for sale, exemption from equity accounting).</td>
</tr>
</tbody>
</table>

The ED proposes additional disclosure requirements, including:

- a description of the nature of operations conducted through joint arrangements;
- an alignment of the disclosures for JVs with those required for associates;
- disclosure of summarised financial information for each material JV and in total for all other JVs.
reinstate disclosure of a list and description of significant subsidiaries and associates

disclosure of current and non-current assets and liabilities of an associate (currently only total assets and liabilities are required to be disclosed).

Who will be affected by the proposals?

For the majority of entities the new standard is unlikely to reshape their balance sheet. This is because in most circumstances accounting for individual assets and liabilities gives the same outcome as proportionate consolidation.

If an entity has rights to individual assets and responsibility for liabilities (and related revenue and expenses) of a joint arrangement, the new standard will have little effect on its financial statements if that joint arrangement is not a legal entity or if it is a legal entity that was previously accounted for using proportionate consolidation. In a similar manner, if an entity has rights only to a share of the outcome of the activities of a joint arrangement, there will be little change if that joint arrangement is a legal entity and was previously accounted for using the equity method.

Where entities have been using proportionate consolidation and are recognising assets and liabilities in their financial statements even though they have no rights to the assets or responsibility for the liabilities, or where those entities that have rights to assets and responsibility for liabilities but are not recognising those rights and responsibilities because they are using the equity method of accounting then the change may be more significant.

The ED contains six examples illustrating the application of the requirements of the IFRS to arrangements in which parties have interests in joint operations, joint assets, joint ventures and joint arrangements.

The comment period for this exposure draft has now closed and the IASB are considering comments made. It is expected that a revised standard will be issued during Q4 of 2008.

Bibliography

IASB Project Summary: Amendments to IAS 31 Interests in Joint Ventures
Further information

Articles

Full text from Business Source Corporate through My CIMA
www.cimaglobal.com/mycima


Abstract only from Business Source Corporate through My CIMA
www.cimaglobal.com/mycima


Books


**Websites**

International Accounting Standards Board (IASB)
IASB update provides summaries of Board decisions. Available from: [www.iasb.co.uk](http://www.iasb.co.uk)
[Accessed 9 October 2007]

IAS Plus
Useful chronological list of developments in international accounting standards, including unofficial summaries of IASB meeting discussions. Available from: [www.iasplus.com](http://www.iasplus.com)
[Accessed 9 October 2007]

**Other online information**

Convergence topic gateway available through My CIMA
Available from: [www.cimaglobal.com/mycima](http://www.cimaglobal.com/mycima)
[Accessed 9 October 2007]

Financial Reporting Community of Practice
An online CIMA discussion forum on financial reporting developments. This is an invitation only forum, so please email tis@cimaglobal.com to gain access.

When an exposure draft is issued by the IASB it will appear in CIMA’s Consultation database. This database provides links to the consultation document.