esma European Securities and Markets Authority

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ESMA/2013/9

IFRS IC
Wayne Upton
Cannon Street 30
London EC4M 6XH
United Kingdom

Agenda item request: Elimination of intercompany profits between an issuer and its joint venture

Dear Mr Upton,

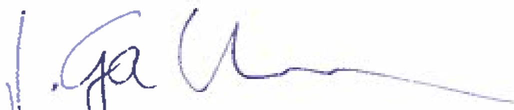
The effective and consistent application of European Securities and Markets legislation is important for ESMA. In the area of financial reporting this is mainly achieved through ESMA's European Enforcers Coordination Sessions (EECS), a forum in which all European national enforcers of International Financial Reporting Standards (IFRS) meet to exchange views and discuss experience with enforcement of IFRS.

As a result of the review of the financial statements carried out by national competent authorities and ESMA's co-ordination activities there is an issue related to the application of IAS 28 – Investments in Associates and Joint Ventures, which we would like to bring to the attention of the IFRS Interpretations Committee for further consideration.

A detailed description of the case is set out in the appendix to this letter.

We would be happy to further discuss these issues with you.

Yours sincerely,



Steven Maijoor
Chair ESMA

Julie Galbo
Chair ESMA's Corporate Reporting Standing Committee

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1. Requirements regarding the application of the equity method of accounting for investments in associates and joint ventures in the consolidated financial statements are included in IAS 28 – *Investments in Associates and Joint Ventures.* European enforcers have come across divergent interpretation of the IFRS requirements in case of certain 'downstream' transactions between the joint venture and the investor when the equity of the joint venture is smaller than the amount of gain to be eliminated from the transaction in the financial statements of the investor.

2. The references provided in this letter relate to IAS 28 (2011) that is applicable for the periods starting on or after 1 January 2013. The requirements under the previous version of IAS 28 (2003) and related requirements in IAS 31 – *Interests in Joint Ventures* and SIC 13 – *Jointly Controlled Entities – Non-Monetary Contributions by Venturers* would lead to substantially the same result.

Description of the issue

3. A joint arrangement was founded by an investor and an unrelated third party, as a separate legal entity. Under IFRS 11 – *Joint Arrangements* the arrangement would be classified as a joint venture (IFRS 11 paragraph 16) and accounted for using the equity method (IFRS 11 paragraph 24).

4. The investor is signing a lease agreement by which it leases fixed assets to its joint venture. The lease was classified as a finance lease (IAS 17 – *Leases* paragraph 10). The investor accounts for a receivable at an amount equal to the net investment in the lease. As a result of the finance lease, the investor records a gain from the sale of the fixed assets in its separate financial statements.

5. The joint venture entity accounts for a leasehold asset and a lease liability in its separate financial statements. At inception of the arrangement, the net equity of the joint venture is not impacted by the lease transaction.

6. For illustrative purposes it is assumed that each venturer owns 50% share of the newly established joint venture for which it paid € 100. The JV's equity thus totals € 200. The book value of the investment in joint venture recognised in the investor's financial statements equals € 100. Further, it is assumed that the book value of the fixed assets derecognised equals to € 50,000 and the book value of the lease receivable to € 90,000. When leasing its fixed assets to the joint venture the investor records a gain from the sale of the fixed assets in its separate financial statements of € 40,000.

7. In its consolidated financial statements, the investor eliminates a portion of the gain from this 'downstream' transaction. In practice, enforcers have encountered two different approaches to the elimination of this gain.

Current practice

View 1

8. Under view 1, the investor eliminates only the portion of the gain on the transaction that does not exceed the book value of the joint venture recognised in its financial statements (€ 100). The remaining intercompany gain amounting to € 19,900 (€ 40,000 x 50% - € 100) is not eliminated.

9. Proponents of view 1 argue that although IAS 28 paragraph 28 requires that the investor's share in the associate's or joint venture's gains resulting from 'downstream' transactions be eliminated, it does not discuss the possibility that the elimination might exceed the carrying amount of the associate or the joint venture.

10. View 1 argues that when using the equity method to account for the joint venture the guidance in IAS 28 paragraph 39 should be applied. This paragraph requires that after the investor's interest in the associate or joint venture is reduced to zero, additional losses are provided for and a liability is recognised only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture. None of these circumstances apply in this case. Even though this paragraph relate to additional losses of the associate or joint venture, proponents of view 1 believe that it is appropriate to analogise this guidance when eliminating gains on intercompany transactions between the investor and the associate or joint venture.

11. Furthermore, besides the carrying amount of the investment, the investor holds no other long-term interest in the joint venture that, in substance, qualifies as an extension of the issuer's net investment in the associate or joint venture according to IAS 28 paragraph 38. The investor's finance lease payment receivable differs in substance from an unsubordinated loan. The investor's long-term lease receivable is reflected in the financial statements of the joint venture as a long-term lease asset and a corresponding long-term lease liability. The ownership of the leased object remains with the lessor, in this case, the issuer. Thus, the investor's lease receivable is similar to a secured loan since the issuer continues to own the equipment according to civil law and can reclaim the asset if the lessee fails to comply with the lease terms.

12. Accordingly, view 1 concludes that analogising with IAS 28 paragraph 39 has priority over IAS 28 paragraph 28. Therefore, instead of eliminating the entire intercompany gain, the investor only eliminates the book value of the joint venture recognised in the investor's financial statements. This

view is supported in several accounting commentaries, including some from the Big 4 accounting firms[1].

View 2

13. Under view 2, the investor eliminates the full amount of the portion of the gain on the transaction, i.e. the remaining intercompany gain exceeding the book value of the joint venture should be eliminated as well (in the example in paragraph 6, full intercompany gain of € 20,000 is eliminated).

14. According to IAS 28 paragraph 28, gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture.

15. 'Downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture. According to this view a financial lease is an example of a downstream transaction that would require recognition of the gain only to the extent of unrelated investors' interests in the associate or joint venture.

16. As the abovementioned paragraph does not allow the recognition of gains resulting from 'downstream' transactions exceeding unrelated investors' interests in the associate or joint venture, this view would require full elimination of the remaining intercompany gain, even that exceeding the carrying amount of the associate or joint venture. Proponents of view 2 argue that analogising with paragraph 39 of IAS 28 is not appropriate as elimination of an intercompany gain has a different characteristic than the recognition of additional losses of the associate or joint venture. In addition, the 'downstream' transaction does not impact the results of the associate or the joint venture but rather the gain is recognized by the investor.

17. Under the previous version of the standard (IAS 31), this view also compared the result of application of the equity method and the proportionate consolidation method. If the proportionate method had been used, the entire intercompany profit would have been eliminated against the leasehold asset hold by the joint venture in the consolidated financial statements (IAS 31 paragraph 48). Therefore, the issuer's results would have been substantially lower when using the proportional method compared with the results applying view 1. Proponents of View 2 question whether such differences between the two methods were intended by the IASB.

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[1] e.g. Deloitte, iGAAP 2012, Chapter A26, Example 4.4.6C (pages 1890-1891).

Request

18. ESMA questions which of the accounting treatment is correct. Paragraph 39 of IAS 28 provides a limit to the loss recognized by the investor when it recognizes its portion of the affiliate's results. At the same time paragraph 28 requires recognition of the gain from upstream or downstream transaction only to the extent of unrelated investors' interests in the associate or joint venture. ESMA notes that in some circumstances these two requirements are considered contradictory, leading to diversity in practice.

19. Accordingly, ESMA suggests that the IFRS IC considers clarifying the accounting requirements in this respect. In particular ESMA suggests that the IFRS IC clarify whether IAS 28 paragraph 38 applies in these circumstances even though no "real" loss occurred, yet the equity investment recognised by the investor is smaller than the portion of the gain to be eliminated.

Further comments

20. Some practitioners also question whether from a consolidated perspective, the investor retains 50% of the risks and rewards associated with the leased asset. Accordingly, questions can be raised whether the leased asset still qualifies as a finance lease as the consolidated group (the reporting entity) has not surrendered substantially all the risks and rewards incidental to ownership of the asset. A further question can be raised as to whether it is possible that the classification of operating and finance lease differs depending on whether the lease transaction is viewed on a single entity or consolidated basis.

21. Acknowledging that these questions could have broader ramifications and relate to existing IASB projects (Leases, Conceptual Framework), ESMA uses this opportunity to encourage the IASB to consider these wider issues within those projects.

Reference to the applicable IFRS requirements

22. Paragraph 28 of IAS 28(2011) states that "*gains and losses resulting from 'upstream' and 'downstream' transactions between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture*". It further specifies that "'*downstream' transactions are, for example, sales or contributions of assets from the investor to its associate or its joint venture*", and that "*the investor's share in the associate's or joint venture's gains or losses resulting from these transactions is eliminated*".

23. Paragraph 38 of IAS 28(2011) requires the entity to discontinue recognizing its share of further losses if an entity's share of losses of an associate or a joint venture equals or exceeds its interest in the associate or joint venture. It further specifies that "*the interest in an associate or a joint venture is the carrying amount of the investment in the associate or joint venture determined using the equity method together with any long-term interests that, in substance, form part of the entity's net investment in the associate or joint venture*".

24. Paragraph 39 of IAS 28(2011) states that "*after the entity's interest is reduced to zero, additional losses are provided for, and a liability is recognised, only to the extent that the entity has incurred legal or constructive obligations or made payments on behalf of the associate or joint venture*".