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Ms Sue Lloyd
International Accounting Standards Board
Columbus Building
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Our ref BOD/288

20 November 2018

Dear Ms Lloyd

Tentative agenda decision: Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11 Joint Arrangements)

We appreciate the opportunity to comment on the IFRS Interpretations Committee's (the Committee) tentative agenda decision *Liabilities in relation to a joint operator's interest in a joint operation (IFRS 11 Joint Arrangements)* (IFRIC Update September 2018). We have consulted with, and this letter represents the views of, the KPMG network.

The agenda item relates to the recognition of lease liabilities when an underlying asset is operated jointly as part of an unincorporated joint operation's activities. We are concerned that, when considered together with the Committee's agenda paper and discussion, the tentative agenda decision could be read to require a lead operator to recognise the entire lease liability, even in cases when it is not the customer in the contract with the asset owner and does not obtain control of the right to use the underlying asset. We are concerned that such a treatment:

- is not consistent with the guidance on identifying a lease in IFRS 16 and represents an exception to the general principle that a customer in a contract that contains a lease recognises a right-of-use asset and lease liability;
- creates confusion as to the circumstances in which the other members of the joint arrangement recognise a share of the right-of-use asset and lease liability;
- is an inappropriate application of paragraphs 20 and B18 of IFRS 11; and
- has wider consequences for the application of joint operation accounting and the creation of structuring opportunities.

For these reasons, we do not believe the Committee should finalise the draft agenda decision in its current form.

Application of IFRS 16

We are concerned that the Committee's agenda paper is not consistent with the guidance on identifying a lease in IFRS 16 and represents an exception to the general principle that a customer in a contract that contains a lease recognises a right-of-use asset and lease liability

The Committee's agenda paper asserts as part of the "fact pattern" [sic] that "The lead operator **enters into a lease**" [emphasis added]. The subsequent analysis focuses on the application of other IFRSs assuming that the lead operator has primary responsibility for a liability. In our view, this is a fatal flaw in the agenda paper, as the analysis thereby bypasses the central interpretive issues – whether the contract with the asset owner creates a liability and, if so, for whom.

We believe that in order to address these issues, it is first necessary to apply the guidance in IFRS 16 on lease definition to the contract with the asset owner. That guidance includes IFRS 16.B11, which states that in certain circumstances the "joint arrangement is the customer in the contract" and the assessment of whether the arrangement contains a lease depends on "whether **the joint arrangement has the right to control the use of an identified asset...**" [emphasis added].

It is therefore necessary to determine whether the lead operator or the joint arrangement is the customer – as this determines whether the lead operator or the joint arrangement is the candidate lessee, and therefore whether the lead operator or the joint arrangement recognises the right-of-use asset and lease liability. This follows from the definition of a lessee – i.e. the party "that obtains the right to use an underlying asset" (IFRS 16.App A). If the lead operator is a lessee in the contract with the asset owner, it is then necessary to consider whether there is a sub-lease from the lead operator to the joint arrangement – see below.

Further, IFRS 16 explains that the joint arrangement can be a customer, regardless of who signed the contract. Indeed, IFRS 16.BC126 specifically envisages that this may be the case when the joint arrangement is unincorporated and only one party signs the contract with the asset owner: "The contract might be signed by the joint arrangement itself if the joint arrangement has its own legal identity, or it might be signed **by one** or more of the parties to the joint arrangement on behalf of the joint arrangement. **In such cases, ...**" [emphasis added].

We are aware that assessing whether the lead operator has signed "on behalf of" the joint arrangement can be a matter of significant judgement, and a variety of fact patterns arise in practice. In order to promote a consistent approach to recognition of lease liabilities in such cases, we have published our own detailed guidance on how to

make this assessment¹. We are disappointed that the Committee has not yet discussed this central issue.

In contrast, the Committee agenda paper argues that if the lead operator is a “sole signatory”, then it may be required to account for a lease even when it does not obtain the right to use an underlying asset. The suggestion that a paying agent rather than the party identified by IFRS 16 as the lessee may be required to account for the lease would open untold structuring opportunities. As a long-term supporter of the recognition of assets and liabilities arising from lease contracts, we reject such a significant exception to the core principle of IFRS 16.

Accounting at the joint operator level

We are concerned that the Committee's agenda paper and discussion has created confusion as to the circumstances in which the other members of the joint arrangement recognise a share of the right-of-use asset and lease liability.

Prior to the Committee's deliberations, it appeared that if the joint arrangement obtained the right to control the underlying asset in the agreement with the asset owner, then each party to the joint arrangement would account for its share of the right-of-use asset and lease liability. Conversely, if the lead operator obtained the right to use the underlying asset in the agreement with the asset owner, then it was necessary to assess whether there was a sub-lease from the lead operator to the joint arrangement.

However, the Committee's deliberations raise questions over the first scenario. The staff paper relies on the joint operation obtaining (collective) control of the right to use the underlying asset in order to conclude there is a lease from the asset owner to lead operator. This calls into question whether there can be a sub-lease from the lead operator to the joint arrangement. Put simply, if the lead operator does not obtain control of the right to use the underlying asset, then it cannot convey control of the right to use the underlying asset to the joint arrangement.

This is not our view – but it is a view we have heard with increasing frequency since the last Committee meeting.

Our understanding has always been that the Board's intention with IFRS 16.B11 was to require the parties to a joint arrangement to recognise their share of lease assets and liabilities when the parties obtain the right to jointly control the use of an underlying asset. We continue to support that intention and our published guidance requires that

¹ “Joint arrangements in the oil and gas industry: Identifying the customer in a contract for the use of assets” – available at KPMG.com/ifrs16

accounting. However, we fear that the Committee's deliberations risk frustrating that intention.

We appreciate that the Committee would be reluctant to expand the scope of its deliberations to consider further the accounting by the other parties to the joint arrangement. Such scope creep is not necessary under our analysis. However, in our view, it is an unfortunate necessity under the analysis set out in the Committee's agenda paper.

Application of IFRS 11

Following from the above we have concerns as to what such an outcome would have for the application of IFRS 11. According to paragraph 20 of IFRS 11, a joint operator recognises its share of assets that are held jointly and liabilities that are incurred jointly. B18 also explains that assets and liabilities are recognised on the basis of the contractual arrangement. This is reinforced by BC38 which makes it clear that the contractual arrangement is the basis for recognition and measurement, and that this requirement would override ownership levels.

We read the tentative agenda decision as contrary to the requirements of IFRS 11 as it reads the lease contract in isolation and ignores the existence of a contractual arrangement that the parties have agreed. Consequently, the lead operator would recognise assets and liabilities more than required under IFRS 11 whilst the other parties would not recognise any lease accounting.

The existence of a 'sublease' has been raised but this should be separately assessed according to the contractual arrangements.

Wider implications to joint operation accounting

Under IFRS 11 the consequence of entering a joint arrangement contract is that other contracts should not be read in isolation but under the umbrella of the arrangement. The provisions of IFRS 11 do not distinguish between types of assets or liabilities but apply to all equally.

Based upon the analysis above we have further concern because the tentative agenda decision would have wider consequences for the application of joint operation accounting beyond the lease accounting. It suggests that one party who signs a contract for a joint operation should recognise the entire assets and liabilities, ignoring agreements between the parties. Operators other than a signatory of a contract would under-recognise assets and liabilities. Consequently, all the parties to the joint operation would not recognise their share of assets and liabilities from joint operations in their financial statements. This creates potential for structuring opportunities.

Clarity of intended message

It will be clear from the foregoing that we have serious concerns about the message that the Committee is intending to convey here. As a final observation on the tentative agenda decision, we are concerned that that message is not clear. The text as written is open to broad interpretation and would not reduce diversity.

Next steps

For the reasons above, we believe that the Committee should not finalise the tentative agenda decision in its current form. We believe the central issue in the fact patterns that prompted the submission to the Committee is how to assess whether the lead operator has signed “on behalf of” the joint arrangement. This is a complex and judgemental issue on which we have published detailed guidance in order to promote consistency of approach. We strongly encourage the Committee to focus its discussions on this central issue in order to avoid the unintended consequences and structuring opportunities that in our view would arise if the agenda decision is finalised in its current form.

Conversely, if the Committee believes that there is a public policy imperative for the lead operator to account for a lease liability as a consequence of signing a contract with a third party irrespective of whether the lead operator obtains control of the right to use an underlying asset, then the Committee should recommend to the IASB that the following IFRSs be amended to require this:

- B11 of IFRS 16 should state a joint arrangement is considered when identifying a lease, but accounting is based on who signs the contract.
- B17 and B18 of IFRS 11 should clarify the meaning of “incurred jointly” to consider the contracts with third parties only.
- IFRS 11 should also clarify the meaning of “held jointly” to consider how assets are recognised when assets are transferred between the joint operators, without third party involvement.

Depending on timing, such amendments could be Annual Improvements, a narrow scope standard-setting project, or considered more holistically as part of the overdue post-implementation review of IFRS 11.



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operation (IFRS 11 Joint Arrangements)*
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We hope you find this letter helpful. Please contact Brian O'Donovan or Peter Carlson at +44 (0) 20 7694 8871 if you wish to discuss any of the issues raised.

Yours sincerely

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