

# Accounting for Joint Ventures

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## **Financial Accounting Standards Board**

### **Consolidations and Related Matters**

In January 1982, the Board added to its agenda a project on consolidations and related matters. The project is intended to cover all aspects of accounting for affiliations between entities along with several other matters that raise similar, or potentially related, issues about financial statements. The project was undertaken in response to numerous questions about consolidation policy and procedures that the American Institute of Certified Public Accountants, the Securities and Exchange Commission and others brought to the Board's attention during the late 1970s. The project is divided into five parts: consolidation policy and procedures, disaggregated disclosures, unconsolidated entities, new basis accounting, and similar matters for not-for-profit entities. To date, consolidation policy and procedures and disaggregated disclosures have been the active phases of the project. An October 1995 Exposure Draft was issued for consolidations policy and procedures, while early 1996 is the projected date of an Exposure Draft for disaggregated disclosures. The next active phase is to be unconsolidated entities.

The unconsolidated entities phase of the consolidations project is intended to address presentation in the investor's financial statements of investments in entities that do not qualify for consolidation as defined in the consolidation policy and procedure's part of the project. In that regard, the Board will be considering the accounting for investments in joint venture and other types of investments that presently are accounted for according to the provisions of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*.

### **Current Accounting for Joint Ventures**

A joint venture may be organized as a corporation (corporate joint venture), as a partnership, or as undivided interests under which each investor owns an undivided interest in each joint venture asset and is liable for its share of each joint venture liability. Although Opinion 18 defines a corporate joint venture, there is not yet a "generally accepted" definition of a joint venture that includes unincorporated entities as well. According to Opinion 18 a corporate joint venture is:

... a corporation owned and operated by a small group of businesses (the "joint venturers") as a separate and specific business or project for the mutual benefit of the members of the group.... The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors.

Opinion 18 requires investors to account for investments in corporate joint ventures by the equity method but it does not address accounting for investments in other types of joint ventures.<sup>1</sup> AICPA Accounting Interpretation 2, "Investments in Partnerships and Ventures" of Opinion 18 states that the equity method would be appropriate in accounting for investments in partnerships and most other unincorporated joint ventures. However, it further states that in some ventures where it is common industry practice for the investor-venturer to own an undivided interest in each asset and to be proportionately liable for its share

of each liability, the investor-venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues and expenses of the venture. 2

Critics have argued that the lack of guidance in the accounting literature for unincorporated joint ventures has led to nonuniformity in accounting practices resulting in the use of the equity method, the cost method, proportionate consolidation, or some combination of methods in the financial statements of investors in joint ventures. Those critics have indicated that different investors with similar investments in joint ventures use different methods to account for the investments. Furthermore, some investors with investments in several unincorporated joint ventures use different methods to account for the separate investments or, for a single investment, use a method of accounting on the balance sheet that is different from the method used on the income statement.

Critics also have argued that the equity method does not provide adequate information about the investor's resources and obligations arising from the joint venture investment, particularly when the joint venture is integrated with the investor's operations and is organized to achieve efficiencies of scale or to share risks. In other instances, the equity method of accounting can provide an opportunity to obtain off-balance-sheet financing since liabilities are netted against assets to report a net investment in the joint venture. Furthermore, the equity method requires the aggregation of the investor's share of revenues and expenses, thereby resulting in a line item on the income statement referred to as *net investment income*. Critics believe that when the joint venture is undertaken to enhance the operations of the investor, the aggregation and reporting of net investment income does not present a true picture of the investor's operations.

Supporters of the equity method argue that unless the investor controls certain identified assets, the assets of the joint venture are not the assets of the investor. Therefore, it is appropriate to record the joint venture as an investment and not as individual assets and liabilities.

### **The Unconsolidated Entities (Joint Venture) Project**

The Board will be investigating those criticisms, plus others, during the course of the project on unconsolidated entities. Most would agree that the overriding question relating to joint venture accounting is whether shared control (or joint control) is sufficiently different from control or significant influence to require a separate method of reporting. Before answering that question, the Board must arrive at generally accepted definitions of *joint venture* and *shared control* for accounting purposes. A 1979 AICPA Issues Paper, *Joint Venture Accounting*, identified seven factors that should be considered in defining a joint venture: (1) legal forms of the entities, (2) characteristics that differentiate the entities as a class from other entities, (3) relationships of the entities to their owners, (4) purposes for which the entities are formed and operated, (5) limits on the number of owners, (6) the nature of joint control, and (7) the duration of the entities. A general definition of joint ventures might be aided by identifying types of joint ventures. In that regard, the Pharmaceutical Research and Manufacturers Association has undertaken a project to assist the Board in gathering information on the key characteristics of joint ventures currently in use today. Other projects of that type would be beneficial to the Board.

The ultimate issue to be decided is the accounting method to be used for reporting investments in joint ventures; and, if more than one method is allowed, the circumstances in which each method should be used. The alternative methods described in the AICPA Issues Paper included) one-line equity method, (2) expanded equity method, (3) proportionate consolidation, (4) cost method, (5) fair market value, and (6) a combination of methods--for example, one method used in the balance sheet and another in the income statement, or different types of methods for different types of joint ventures. In examining the alternatives available and the circumstances in which each method should be used, the Board would benefit from research aimed at the impact that each method has on decisions of users and management.

Another issue that will need to be addressed is the types of disclosures that should be required for investments in joint ventures. Disclosures could include separate financial statements or summarized financial information of joint ventures, a description of the investor's relationships with joint ventures, fair market value of investments in joint ventures, and information about operating, financing and other special agreements, arrangements, or commitments that the investor may have with joint ventures.

### **The Need for *Ex Ante* Research**

The mission of the Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors and users of financial information. To accomplish that mission, the Board acts to improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency. Ultimately, the information required to be provided by standards should be useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions. In that regard, the Board could benefit from ex ante research. Since the project on joint venture accounting is soon to become active, now is the time that behavioral researchers could begin examining the issues discussed above.

1 Cheri L. Reither is an assistant project manager and Ronald W. Lott is a project manager, both with the Financial Accounting Standards Board. The views expressed in this paper are those of the authors. Official positions of the Financial Accounting Standards Board are determined only after extensive due process and deliberation.

2 Accounting by the investor for its *pro rata* share of assets, liabilities, revenues and expenses of the venture is referred to by some as *proportionate consolidation*. However, the FASB has not adopted that term in any of its pronouncements.

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