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Point of view
Accounting for joint arrangements in the energy and resources sector

In a nutshell

- IFRS 11 *Joint arrangements* is now effective – *effective date* ***1 January 2013*** (1 January 2014 for EU preparers).
- IFRS 11 focuses on rights to assets and obligations for liabilities of the parties to the arrangement rather than merely the structure of the arrangement. The nature of those rights and obligations are the basis for classifying the arrangement as a joint venture or a joint operation.
- Investors in joint venture entities can no longer use proportionate consolidation – this will impact financial data and ratios. Investors in joint operations account for their share of assets, liabilities, revenue and expenses.

What's changed?

IFRS 11 has some significant implications for the energy and resources industry relating to the classification, accounting and disclosures of joint arrangements.

IFRS 11 sets out new requirements for accounting for joint arrangements. IFRS 11 classifies joint arrangements into two types – joint operations and joint ventures – each having its own accounting model. The key distinguishing factor between the two types of arrangements is based on the nature of the rights and obligations of the parties to the arrangement. In a joint operation, the parties to the joint arrangement (referred to as 'joint operators') have rights to the assets and obligations for the liabilities of the arrangement. By contrast, in a joint venture, the parties to the arrangement (referred to as 'joint venturers') have rights to the net assets of the arrangement.

One of the most significant changes is the removal of the option to proportionately consolidate joint venture entities. This will mean that revenues and expenses that flow from the joint venture can no longer be presented separately in the financial statements of the parties with joint control over the joint venture. Instead, under the equity method, they will show the net profit as a single line in their income statement. Similarly, the assets and liabilities of a joint venture are shown as a single net investment in the balance sheet. In contrast, parties with joint control over a joint operation recognise separately their share of the assets, liabilities, revenues and expenses relating to the joint operation within the relevant line items in their financial statements in accordance with applicable IFRSs.

Change in classification could impact revenue, net assets and affect covenants

Whether a joint arrangement is a joint venture or a joint operation is, therefore, a significant judgement for many companies, potentially affecting KPI's, remuneration targets and bank covenants.

What is a joint arrangement?

IFRS 11 defines a 'joint arrangement' as "an arrangement of which two or more parties have joint control". Joint control exists when the unanimous consent of those parties sharing control is required to make decisions about the relevant activities. Relevant activities are those activities that significantly affect the returns on the arrangement.

How should joint arrangements be classified?

The key distinguishing factor between a joint venture and a joint operation is based on the nature of the rights and obligations of the parties to the arrangement.

Under IFRS 11, when there is no separate vehicle in place, the joint arrangement would be classified as a joint operation because without the existence of such a vehicle, the parties have rights to the individual assets and obligations for the individual liabilities of the arrangement. A separate vehicle is a separately identifiable financial structure, including legal entities or entities recognised by statute, regardless of whether those arrangements have a legal personality. This analysis is generally consistent with the application of IAS 31.

The existence of a separate vehicle is typically designed to achieve separation between the parties and the joint arrangement conferring an interest in the net assets of the separate vehicle rather than rights to assets and obligations for liabilities.

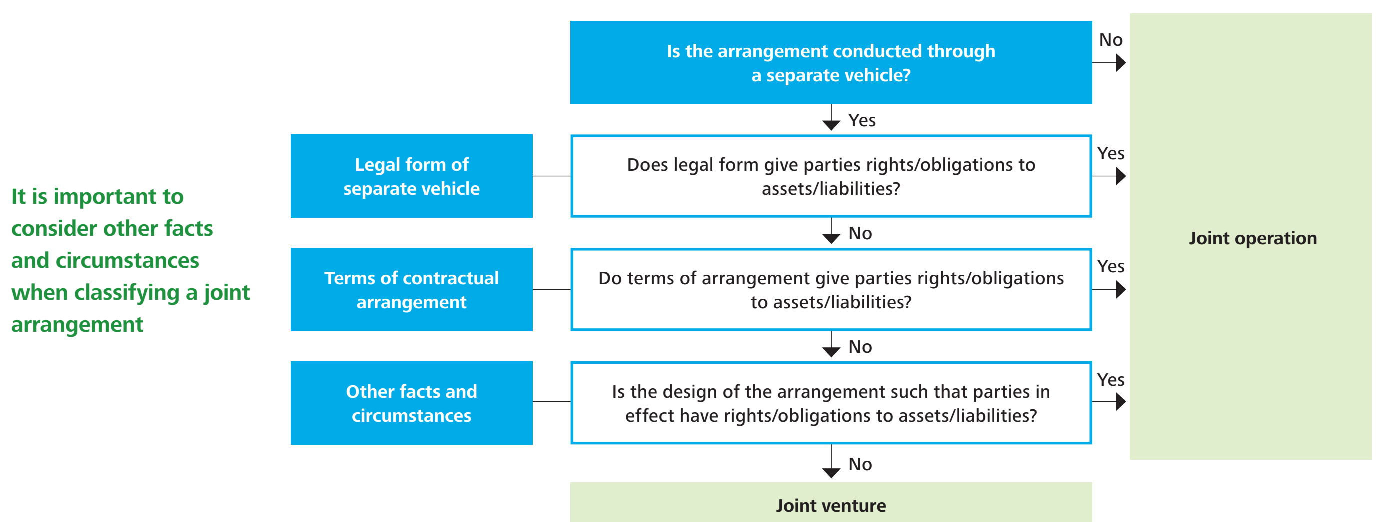
However, in a change from IAS 31, a legal entity or structure-based distinction does not direct classification in and of itself. IFRS 11 carves out from the structure-based population those arrangements in which the separation is overcome by the legal form, contractual terms, or other facts and circumstances. In many cases, the rights and obligations of each of the parties conferred by the legal form of the separate vehicle will be consistent with those in the contractual arrangement between them. Where this is so, it provides an initial indication that the joint arrangement is a joint venture as it evidences that the parties to the arrangement have an interest in the net assets (and not a direct interest in its assets and liabilities).

In other situations, contractual arrangements may modify the rights and obligations of the parties conferred by the legal form resulting in a direct interest in the assets and liabilities of the arrangement. For example, if a separate vehicle is formed to hold the assets and liabilities of the joint arrangement and the parties involved have the rights to 'substantially all' of the economic benefits of the arrangement's assets (e.g., the parties have committed to purchase all of the arrangement's output), and the parties are substantially the only source of cash flows contributing to the arrangement's operations, this generally indicates that the arrangement is a joint operation. However, if the joint arrangement was able to generate operational cash flows from third parties, this would indicate the joint arrangement is a joint venture because the joint arrangement would assume demand, inventory, and credit risks.

Detailed analysis will usually be required to determine whether the vehicle should be considered in its own right and therefore considered a joint venture or whether due to other information including but not limited to the legal form of the arrangement and the contractual terms it should be considered a joint operation.

IFRS 11 provides the following guidance on factors to consider in the classification of a joint arrangement:

It is important to consider other facts and circumstances when classifying a joint arrangement



What are key considerations for joint operation classification?

- **Rights and obligations:** need both rights to assets and obligations for liabilities.
- **Substantially all:** parties need to have rights to 'substantially all' the assets and be 'substantially' the only source of cash flows – generally presumed to mean 90% or more.
- **Output:** a right, expectation and/or intention to purchase output is not enough to result in an obligation for the liabilities of the joint arrangement and it is necessary to establish that the cash flows from the parties are the principal means of servicing those liabilities.
- **Guarantee:** a guarantee for the liabilities of the arrangement is not enough to result in an obligation.
- **Cash call:** may result in an obligation, depending on the nature of the cash call. For example:
  - a cash call that provides the primary ongoing source of funding to the arrangement indicates an obligation; whereas
  - a cash call that provides the funding only in case of a shortfall does not indicate an obligation.
- **Assessment period:** the whole life and all phases of the arrangement need to be assessed.

What are some practical examples in the energy and resources sector?

One of the main challenges of IFRS 11 is that it requires careful consideration of the facts and circumstances of each joint arrangement to establish the appropriate accounting under the standard. Accordingly, there are no 'bright lines' or benchmarks and it is a matter of applying the principles of the standard to each arrangement and based on that exercising judgement about how it should be classified.

The table below highlights examples showing the practical, sector specific application of these considerations and their implications for the energy and resources sector – these are not intended to be comprehensive or definitive but to assist in the analysis required by the standard.

Features of a joint arrangement	Things to consider	Implications
Example 1 ***Structure of the arrangement*** For example, production sharing agreements for oil and gas fields	• Is the arrangement structured through a separate vehicle? • How is the output shared?	An arrangement that is not structured through a separate vehicle will be classified as a joint operation. For example: in a Production Sharing Agreement (PSA) between an Entity (A) and the Government (G), A has a 80% working interest and is the operator but G, the 20% working interest holder, has the right to vote on major decisions over relevant activities, which require unanimous consent.Under the terms of the PSA, A bears all of the exploration risk. If exploration is successful and production commences, A sells the oil produced and is entitled to i) recover its share of capital and operational expenditures through sales (cost oil) and ii) thereafter split revenues on profit oil 80:20 with G in line with the relative working interests outlined in the PSA. The parties with joint control over the joint operation recognise their share of the assets, liabilities, revenues and expenses in accordance with rights and obligations as set out in the agreement.
Example 2 ***The purpose of the arrangement*** For example, in the mining industry, when 100% of output is for the benefit of the shareholders to purchase at a fixed price	• Does the agreement specify that the shareholders have rights to the assets and obligations for the liabilities relating to the arrangement? • If not, are there other facts and circumstances related to how the arrangement operates including any sharing of the output of the arrangement?	When the activities of a joint arrangement within a legal entity are designed for the provision of output to the shareholders, it is necessary to establish whether the existence of offtake agreements confers a direct interest in the assets and liabilities of the joint arrangement. When the parties have a right or intention to purchase the output of a joint arrangement at a fixed price it is not a sufficient condition to establish that the parties have an obligation for the liabilities of the arrangement. With only a right, the parties could choose not to purchase some or all of the output at that fixed price, in which case the joint arrangement could sell the output to third parties at market rates and use the proceeds to settle its liabilities, even if sales to third parties is not the parties' intention. Accordingly, whilst the arrangement may have been established with the purpose and design of providing the parties with substantially all of the output at a fixed price, in order for the analysis of other facts and circumstances to lead to the conclusion it is a joint operation, the parties have to be obligated to purchase substantially all the output and thus be the source of substantially all the cash flows used to pay the obligations. Without such an obligation, because it is possible that the joint arrangement has, or could have, other potential sources of cash from sales to third parties, the parties have an interest in the net assets and not to the rights and obligations of the joint arrangement – supporting classification as a joint venture rather than a joint arrangement.
Example 3 ***Reconciling ownership interests with the benefits derived from the arrangement*** For example the impact of "asymmetric output" between off takers in power and utilities	• Is there a mismatch between the ownership share in an arrangement and the ratio of output between the parties? • What other facts and circumstances are there to explain the benefits derived from the arrangement by each of the parties that may serve to compensate for a greater/lesser share of output relative to ownership interests?	If there is a mismatch, it is necessary to look through to the substance of the arrangement and its operation to understand how the parties derive their respective benefits and are exposed to the risks in the arrangement, for example through preferential dividend or interest payments on capital or debt investments. It is then necessary to account for the rights and obligations that flow from the operation of the arrangement which may be more complex than simply considering ownership interest or share of output.

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Designed and produced by The Creative Studio at Deloitte, London. 29168A