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IFRS industry insights

Joint arrangements in the energy and resources industry

The most significant change will likely be the removal of the option to proportionately consolidate joint venture entities.

On 12 May 2011, the International Accounting Standards Board (IASB) issued IFRS 11 *Joint Arrangements* which supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly Controlled Entities – Non-Monetary Contributions by Venturers*. Concurrent with the issuance of IFRS 11, the IASB also issued:

- IFRS 10 *Consolidated Financial Statements*;
- IFRS 12 *Disclosure of Involvement with Other Entities*;
- IAS 27 *Separate Financial Statements* (revised 2011), has been amended for the issuance of IFRS 10 but retains the current guidance for separate financial statements; and
- IAS 28 *Investments in Associates and Joint Ventures* (revised 2011), has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11.

Each of the standards in the 'package of five' has an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted so long as each of the other standards in the 'package of five' are also early applied. However, entities are permitted to incorporate any of the disclosure requirements in IFRS 12 into their financial statements without early adopting IFRS 12 (and thereby the standards in the 'package of five').

IFRS 11 and IFRS 12 may have some significant implications for the oil and gas industry relating to the classification, accounting and disclosures of joint arrangements. The most significant change will likely be the removal of the option to proportionately consolidate joint venture entities. The application of these new standards will require judgement, time, resources and consideration given the complexity of many of the joint arrangements.

Background

Jointly-controlled entities, assets and operations are widely used across the oil and gas industry for various reasons, for example, as a means of sharing risk, raising finance, bringing in additional expertise or introducing a government stakeholder.

IFRS 11 sets out new rules for accounting for joint arrangements that focus on the parties' rights and obligations under the arrangement, rather than the legal form. This is in contrast to the requirements under IAS 31 *Interests in Joint Ventures*.

IFRS 12 requires extensive disclosures relating to an entity's interests in joint arrangements, as well as in subsidiaries, associates and unconsolidated structured entities. An entity is required to disclose information that helps users of its financial statements evaluate the nature of and risks associated with its interests in other entities and the effects of those interests on its financial statements.

Definition

IFRS 11 defines a joint arrangement as "an arrangement of which two or more parties have joint control", and goes further to establish two categories of joint arrangements – joint operations and joint ventures. 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. The terminology used in IFRS 11 may be particularly confusing in the oil and gas industry where most types of joint arrangements are commonly described as 'joint ventures'. However, the type of joint arrangement is important because the accounting will depend on whether the arrangement is a joint venture or joint operation.

However, in a change from IAS 31, an arrangement that includes a separate legal vehicle is not precluded from being accounted for as a joint operation.

Under IFRS 11, when there is no separate legal vehicle in place, the 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 individual obligations for the liabilities of the arrangement. This analysis is generally consistent with the application of IAS 31. However, in a change from IAS 31, an arrangement that includes a separate legal vehicle is not precluded from being accounted for as a joint operation. All relevant facts and circumstances need to be considered in determining whether the parties to the arrangement have the rights to the net assets of the arrangement (joint venture), or direct rights and obligations to the assets and liabilities of the arrangement (joint operation).

IFRS 11 provides guidance on factors to consider in the identification of a joint venture.

Legal form of the separate vehicle

A joint arrangement that is conducted through a separate vehicle may offer the investors no limitation on the liability of the parties to that arrangement. This indicates that the joint arrangement is a joint operation. However, a joint arrangement that limits the liability of the parties would not necessarily indicate that the arrangement is a joint venture because the terms of the contractual arrangement or other facts and circumstances may affect whether the parties have limited liability.

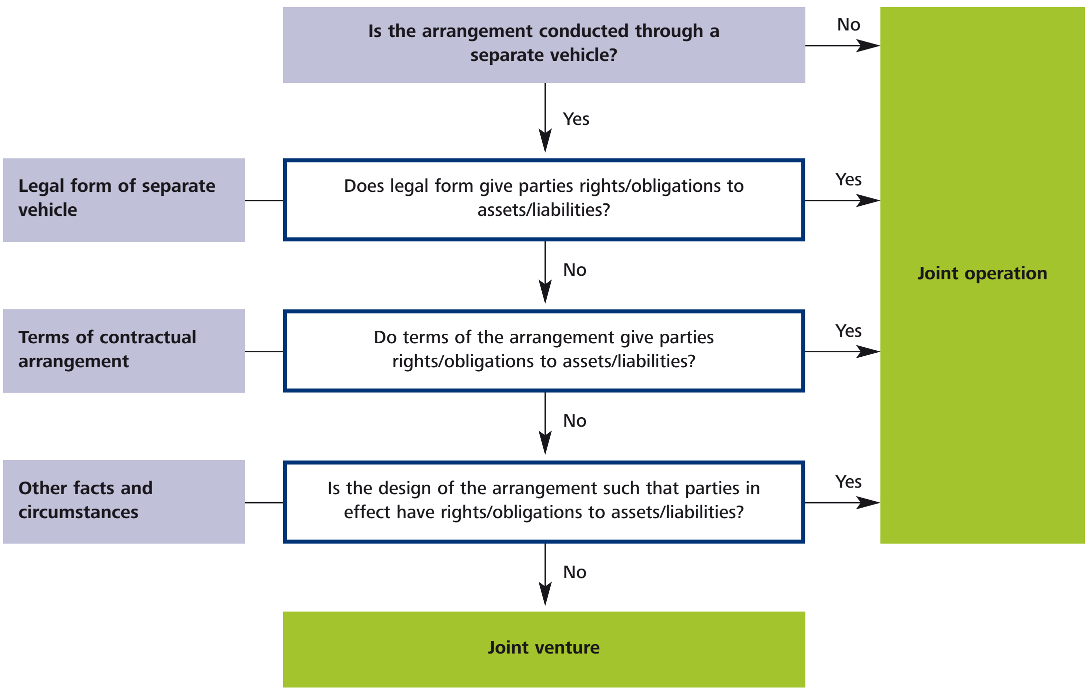
Terms of the contractual arrangement

Contractual arrangements between the parties to the joint arrangement may counteract the legal form of the vehicle. For example, parties may have direct rights to the assets and obligations for the liabilities of the arrangement despite the fact that the legal form of the vehicle would normally shelter the investors from having a direct obligation for its liabilities. This would be the case if the contractual arrangement between the parties establishes that all parties to the arrangement are directly liable for third party claims, or establishes a sharing of revenues and expenses based on the relative performance of the parties.

Other facts and circumstances

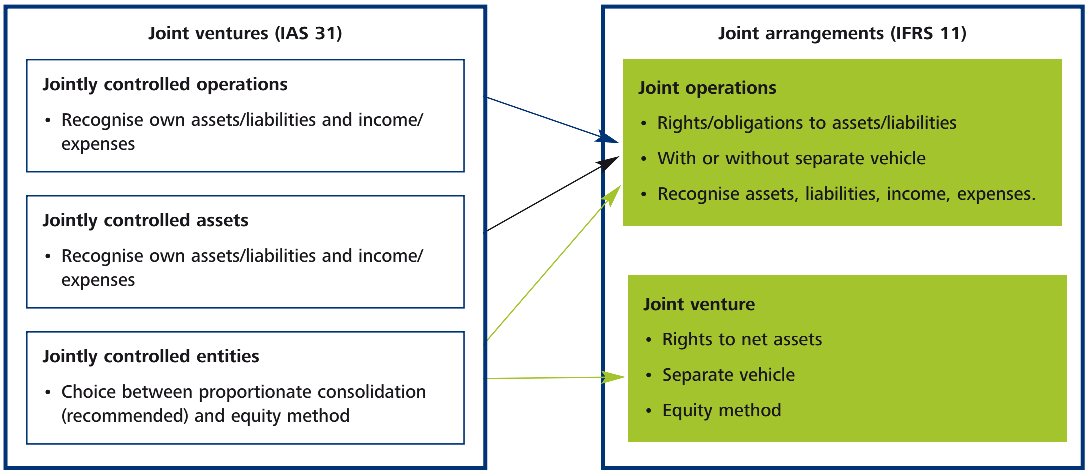
When a separate vehicle is used and the terms of the contractual arrangement do not indicate that the joint arrangement is a joint operation, the parties should consider any other relevant facts and circumstances in determining the type of arrangement. For example, if a separate vehicle is formed to hold the assets and liabilities of the joint arrangement and the parties to the joint arrangement are committed to purchase the entire output of the arrangement, this indicates that the arrangement is a joint operation, because the parties have rights to all of the economic benefits generated by the asset of the arrangement. Additionally, the parties are required to fund the settlement of the liabilities of the joint arrangement, because the arrangement is exclusively dependent on the parties for the generation of cash flows. This also indicates that the arrangement is a joint operation. However, if the joint arrangement was able to sell output to third parties because the joint arrangement would assume demand, inventory and credit risks, this would indicate the joint arrangement is a joint venture.

As illustrated below, all relevant factors must be considered in order to determine that a joint arrangement meets the definition of a joint venture.



Additionally, there may be several arrangements within a single vehicle or master contract agreement where parties have different rights to the assets and obligations for the liabilities.

The comparative application of these descriptions to joint venture arrangements is set out below:



In the oil and gas industry, a party that holds an interest in, and jointly controls, an oil and gas asset or licence through, for example, an unincorporated joint venture would account for its interest as an interest in a joint operation under IFRS 11. This is consistent with the existing practice of accounting for unincorporated joint ventures.

Conversely, a party that holds an interest in an incorporated entity that is jointly controlled in which the parties have rights to the net assets would account for its interest as an interest in a joint venture under IFRS 11. However, if the terms of the arrangement or other facts and circumstances indicate that the parties have rights to the assets and liabilities for the obligations of the incorporated entity, each party would account for its interest as an interest in a joint operation even though a legal entity was used.

Additionally, there may be several arrangements within a single vehicle or master contract agreement where parties have different rights to the assets and obligations for the liabilities. Although these joint arrangements are governed under the same framework agreement, if the parties' rights and obligations differ, the type of joint arrangement may differ.

The following example is adapted from example 5 of IFRS 11:

Facts

Companies A and B set up a separate vehicle (Entity H) and a Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities in country O. The main feature of Entity H's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). Country O has granted Entity H permits for the oil and gas exploration, development and production activities to be undertaken in a specific assigned block of land (fields).

The shareholders' agreement and JOA agreed by the parties establish their rights and obligations relating to those activities. The Board of Entity H consists of a director from each party. Each party has a 50 percent shareholding in Entity H. The unanimous consent of the Directors is required for any resolution to be passed.

The JOA establishes an Operating Committee. This Committee consists of one representative from each party. Each party has a 50 percent participating interest in the Operating Committee. The Operating Committee approves the budgets and work programmes relating to the activities, which also require the unanimous consent of the representatives of each party. One of the parties is appointed as operator and is responsible for managing and conducting the approved work programmes. The JOA specifies that the rights and obligations arising from the exploration, development and production activities shall be shared among the parties in proportion to each party's shareholding in entity H. In particular, the JOA establishes that the parties share the rights and the obligations arising from the exploration and development permits granted to entity H (e.g., the permits, rehabilitation liabilities, any royalties and taxes payable), the production obtained and all costs associated with all work programmes. The costs incurred in relation to all the work programmes are covered by cash calls on the parties. If either party fails to satisfy its monetary obligations, the other is required to contribute to Entity H the amount in default. The amount in default is regarded as a debt owed by the defaulting party to the other party.

The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle.

Conclusion

The parties carry out the joint arrangement through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The parties have been able to reverse the initial assessment of their rights and obligations arising from the legal form of the separate vehicle in which the arrangement is conducted. They have done this by agreeing terms in the JOA that entitle them to rights to the assets (e.g., exploration and development permits, production, and any other assets arising from the activities) and obligations for the liabilities (e.g., all costs and obligations arising from the work programmes) that are held in Entity H. The joint arrangement is a joint operation. Both parties recognise in their financial statements their own share of the assets and of any liabilities resulting from the arrangement on the basis of their agreed participating interest. On that basis, each party also recognises its share of the revenue (from the sale of their share of the production) and its share of the expenses.

The following example is adapted from example 6 of IFRS 11:

Facts

Company A owns an undeveloped gas field that contains substantial gas resources. Company A determines that the gas field will be economically viable only if the gas is sold to customers in overseas markets. To do so, a liquefied natural gas (LNG) facility must be built to liquefy the gas so that it can be transported by ship to the overseas markets. Company A enters into a joint arrangement with Company B in order to develop and operate the gas field and the LNG facility. Under that arrangement, Companies A and B agree to contribute the gas field and cash, respectively, to a new separate vehicle, Entity C. In exchange for those contributions, the parties each take a 50 percent ownership interest in Entity C. The main feature of Entity C's legal form is that it causes the separate vehicle to be considered in its own right (i.e., the assets and liabilities held in the separate vehicle are the assets and liabilities of the separate vehicle and not the assets and liabilities of the parties). The contractual arrangement between the parties specifies that:

- Companies A and B must each appoint two members to the Board of Entity C. The Board of Directors must unanimously agree the strategy and investments made by Entity C.

- Day-to-day management of the gas field and LNG facility, including development and construction activities, will be undertaken by the staff of Company B in accordance with the directions jointly agreed by the parties. Entity C will reimburse Company B for the costs it incurs in managing the gas field and LNG facility.

- Entity C is liable for taxes and royalties on the production and sale of LNG as well as for other liabilities incurred in the ordinary course of business, such as accounts payable, site restoration and decommissioning liabilities.

- Companies A and B have equal shares in the profit from the activities carried out in the arrangement and, as such, are entitled to equal shares of any dividends distributed by Entity C.

The contractual arrangement does not specify that either party has rights to the assets, or obligations for the liabilities, of Entity C. The Board of Entity C decides to enter into a financing arrangement with a syndicate of lenders to help fund the development of the gas field and construction of the LNG facility. The estimated total cost of the development and construction is CU1,000 million. The lending syndicate provides Entity C with a CU700 million loan. The arrangement specifies that the syndicate has recourse to Companies A and B only if Entity C defaults on the loan arrangement during the development of the field and construction of the LNG facility. The lending syndicate agrees that it will not have recourse to Companies A and B once the LNG facility is in production because it has assessed that the cash inflows that Entity C should generate from LNG sales will be sufficient to meet the loan repayments. Although at this time the lenders have no recourse to Companies A and B, the syndicate maintains protection against default by Entity C by taking a lien on the LNG facility.

Conclusion

The joint arrangement is carried out through a separate vehicle whose legal form confers separation between the parties and the separate vehicle. The terms of the contractual arrangement do not specify that the parties have rights to the assets, or obligations for the liabilities, of Entity C, but they establish that the parties have rights to the net assets of Entity C. The recourse nature of the financing arrangement during the development of the gas field and construction of the LNG facility (i.e., Companies A and B providing separate guarantees during this phase) does not, by itself, impose on the parties an obligation for the liabilities of Entity C (i.e., the loan is a liability of Entity C). Companies A and B have separate liabilities, which are their guarantees to repay that loan if Entity C defaults during the development and construction phase. There are no other facts and circumstances that indicate that the parties have rights to substantially all the economic benefits of the assets of Entity C and that the parties have an obligation for the liabilities of Entity C. The joint arrangement is a joint venture. The parties recognise their rights to the net assets of Entity C as investments and account for them using the equity method.

IFRS 11 requires the use of the equity method of accounting for interests in joint ventures.

Accounting

One of the most significant impacts of the new standard comes around the accounting for joint arrangements. Whilst the accounting for joint operations remains similar to that prescribed under IAS 31, such that a joint operator accounts for its share of assets, liabilities, revenues and expenses on a line by line basis in accordance with the applicable IFRSs, the accounting choice of proportionate consolidation for joint ventures under IAS 31 has been removed. IFRS 11 requires the use of the equity method of accounting for interests in joint ventures. This change will affect many companies in the oil and gas industry, as oil and gas companies which operate under legal joint venture arrangements often choose to use proportionate consolidation to account for their interest under IAS 31. This will be particularly significant for those with a majority of their income deriving from joint venture arrangements.

Any oil and gas companies that have previously accounted for their interest in joint ventures using the proportionate consolidation method will have to transition to the equity method. The elimination of proportionate consolidation is intended to bring improved comparability between entities by removing the policy choice. The use of the equity method of accounting will result in one net result and one single net investment balance being reported as compared to a line by line presentation using the proportionate consolidation method. The change in presentation will affect entities' financial statement line items. For example, revenues and expenses will decrease as the venturers will not present their share of the joint ventures' revenue and expenses as part of their own revenue and expenses. Additionally, tangible and intangible assets and liabilities will be reduced as the line by line presentation of the venturers' share of the tangible assets, intangible assets, other assets and liabilities is replaced by a single net investment amount.

Also, the elimination of the option to apply proportionate consolidation will affect those joint ventures that are in a net liability position. Under the equity method of accounting, if an investor's share of cumulative losses in the joint venture exceeds its interest in the joint venture, then unless they have a legal or constructive obligation to fund the deficit, the investor discontinues recognising its share of further losses. Under proportionate consolidation, the investor would continue to recognise its share of the losses in profit or loss.

Example:

- A joint venture was set up between parties A and B in January 2010, with net assets of CU200m.
- Each party has a 50 percent interest in the net assets of the joint venture and neither party has an obligation to fund the joint venture if it enters into a deficit position.
- In 2010, the joint venture incurred a loss of CU(100m), with net assets reduced to CU100m
- In 2011, the joint venture incurred a loss of CU(150m), resulting in net liabilities of CU(50m).
- In 2012, the joint venture incurred a loss of CU(200m), with the net liabilities increasing to CU(250m).
- The parties chose to apply proportionate consolidation to their interest in the joint venture under IAS 31.

The following illustrates the financial statement effect of changing from applying proportionate consolidation to applying the equity method of accounting:

Proportionate consolidation			
Each party's share of the results of the joint venture would be recognised on a line by line basis as follows:			
	2010	2011	2012
Income statement	Loss of CU50m	Loss of CU75m	Loss of CU100m
Balance sheet	Net assets of CU50m	Net liabilities of CU25m	Net liabilities of CU125m

Equity accounting			
Each party's share of results would be recognised on a single line as follows:			
	2010	2011	2012
Income statement	Loss of CU50m	Loss of CU50m	n/a
Balance sheet	Investment of CU50m	Investment of nil	Investment of nil

… oil and gas companies that present reserves from their interests in associates separately from their consolidated reserves may decide to split out their reserves from their interests in joint ventures …

In applying the equity method of accounting, if the joint venture were to return to profitability, each party would commence recognising their share of the profits only after its share of the profits equals the share of losses not recognised.

There are a number of other accounting consequences when applying the equity method of accounting rather than proportionate consolidation. For example:

- Under the equity method of accounting, the elimination of transactions between the investor and the joint venture is often limited to unrealised profits, whereas all such transactions are eliminated using proportionate consolidation (to the extent of the investor's interest in the joint venture)
- Amounts owed by a venturer to a joint venture, and vice versa, are not eliminated under the equity method of accounting, whereas those amounts are eliminated using proportionate consolidation (to the extent of the investor's interest in the joint venture)

Additionally, oil and gas companies that present reserves from their interests in associates separately from their consolidated reserves may decide to split out their reserves from their interests in joint ventures, as, like associates, these will be accounted for using the equity method.

Comparatives

IFRS 11 is effective for annual periods beginning on or after 1 January 2013. If the adoption of IFRS 11 requires a change in accounting, the comparative period will require restatement. This would be the case in the following two circumstances:

Disclosures

IFRS 12 provides the disclosure requirements for an entity's interests in joint arrangements, as well as interests in subsidiaries, associates and unconsolidated structured entities. An entity has an interest in one or more joint arrangements should disclose the following:

Significant judgements and assumptions: An entity should disclose information about significant judgements and assumptions it has made in determining whether it has control, joint control or significant influence, and the type of joint arrangement where the arrangements has been structured through a separate vehicle (joint operation or joint venture).

Interests in joint arrangements (and associates): An entity should disclose information about the nature, extent and financial effects of its interests in joint arrangements, including information about contractual relationships with the other parties to the joint arrangements. An entity should also disclose the nature of, and changes in, the risks associated with its interests in joint arrangements.

IFRS 12 requires that for each material joint arrangement the information should be provided separately. However, it also permits aggregation of some information within each class of entity, so long as the level of detail provided through disclosures satisfies the needs of the users of the financial statements but does not result in excessive detail. It outlines that consideration should be given to both qualitative and quantitative information about the risks and returns of each entity when considering the level of aggregation.

Before (IAS 31)	After (IFRS 11	As at beginning of first comparative period
Jointly controlled entity Equity method	Joint operation	1. Derecognise the equity method investment. 2. Recognise assets (incl. goodwill) and liabilities. 3. If net assets recognised > equity method investment → reduce goodwill (if any) with any excess against retained earnings. 4. If net assets recognised < equity method investment → difference against retained earning.
Jointly controlled entity Proportionate consolidation method	Joint venture	1. Derecognise assets (incl. goodwill, if any), and liabilities. 2. Recognise equity method investment. 3. Perform impairment loss test on opening balance of investment and impairment loss, if any, recognised as adjustment to retained earnings.

Other considerations

- **Internal information systems:** Oil and gas entities may need to review their internal information systems to determine if there is a need to modify their internal systems and processes to gather necessary information to comply with new disclosure requirements.

- **Performance:** Oil and gas entities should consider the implications of the change in the presentation of financial results on key performance indicators (e.g. leverage ratios, gross margin ratios, return on assets ratios), covenants, existing contracts (e.g. debt covenants, remuneration agreements) and regulatory disclosures.

- **Segment reporting:** Oil and gas entities that move from proportionate consolidation to the equity method of accounting should consider the affect of IFRS 11 on internal management reporting and the way management views the business and makes strategic and operating decisions. IFRS 8 *Operating Segments* requires disclosure of segment information on the same basis as it is provided to the company's chief operation decision maker (CODM). If the CODM is presented with information prepared using proportionate consolidation, that basis that would continue to be presented in the segment information but would need to be reconciled to the primary financial statements.

- **New and existing contracts:** Oil and gas entities will need to consider the affect of IFRS 11 as they negotiate new contractual arrangements and modify existing arrangements.

- **Tax consequences:** If the joint venture is profitable and taxable, the transition will decrease profit before tax as tax expenses of the joint arrangement will no longer be included in the tax line. Entities will also need to consider if there are any further tax implications from adopting IFRS 11.

- **Other accounting policy changes:** Oil and gas entities should consider if there are accounting policies that are no longer required to be disclosed as they relate only to the underlying joint venture. For example, a venture will no longer be able to apply hedge accounting upon transition to the equity method of accounting if the entity had previously applied proportionate consolidation and hedged a joint venture's asset or liability.

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