IFRS 11: *Joint Arrangements*

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IFRS 11 *Joint Arrangements*
Contents

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Developing IFRS 11 *Joint Arrangements*

- Added to Agenda in 2003
- Initial outreach by national standard setters from Australia, Malaysia and New Zealand
- Exposure Draft published in September 2007
- Effective Date
  - Annual periods beginning on/after 1 January 2013, with earlier application permitted
- Main Objectives
  - Elimination of accounting choice
  - Introducing a principles based approach
  - Improve consistency
  - US GAAP convergence

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Developing IFRS 11 *Joint Arrangements*
Why change?

IAS 31 *Interests in Joint Ventures*

- The structure of an arrangement (i.e. whether there was a separate legal entity or not) was the principal factor of classification

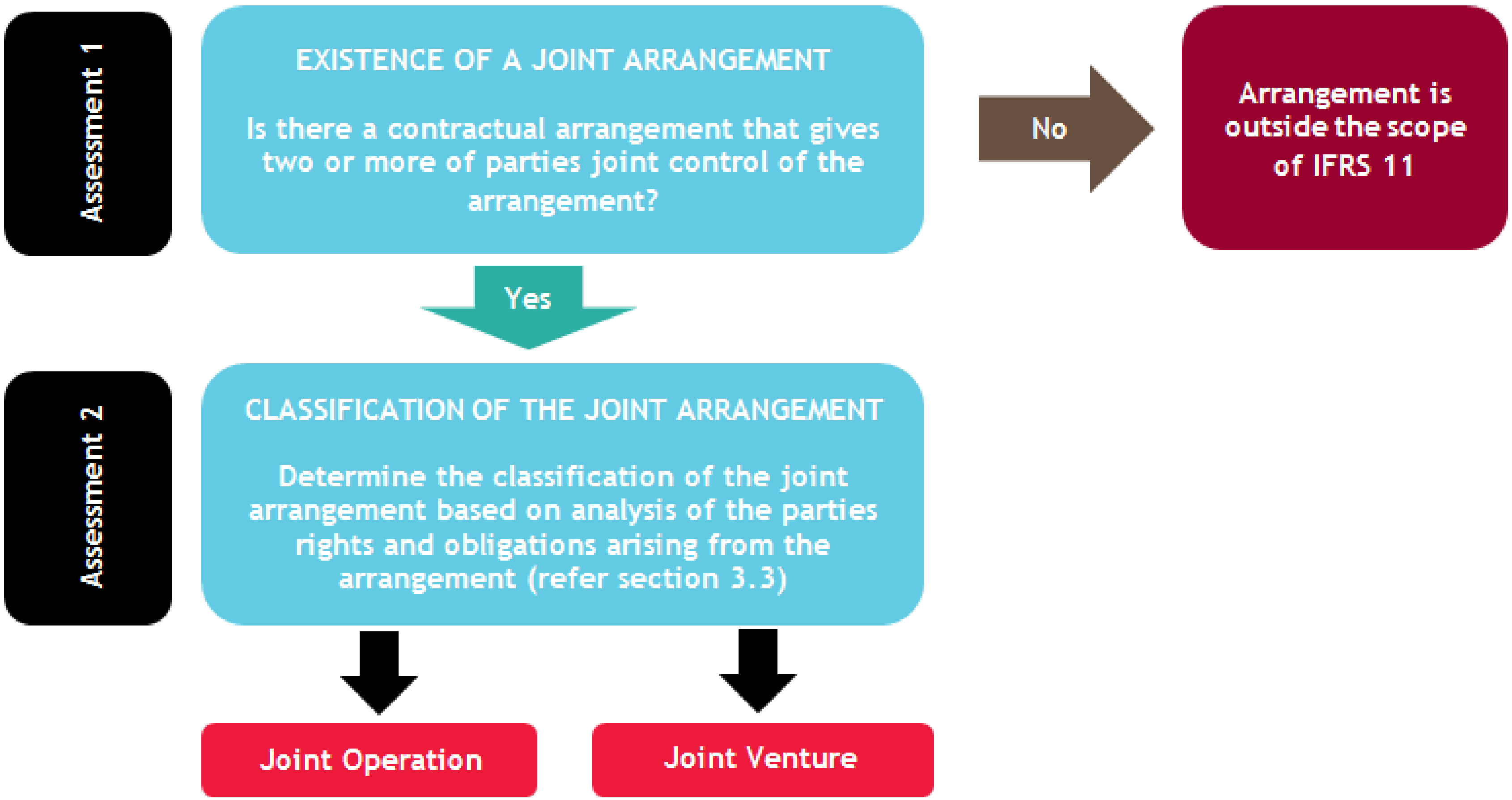
- Options to account for jointly controlled entities
  - Proportionate consolidation
  - Equity accounting

- Inconsistent accounting between entities
  - E.g. similar entities could be accounted for differently
  - E.g. dissimilar entities could be accounted for in the same way

What has changed?
Differences

- joint arrangements are either *joint operations* or *joint ventures*
- Terminology:
  - *Jointly controlled operations* and *jointly controlled assets* are now termed *joint operations*
  - *Jointly controlled entities* are now termed *joint ventures*.
- Joint ventures must be equity accounted
  - Option to proportionately consolidate is **no longer permitted.**
- Structuring through a separate vehicle no longer determines classification (and hence subsequent measurement).
  - Must also consider other rights to assets and obligations for liabilities.
- Definition of [joint] control – refer IFRS 10

IFRS 11: The model
The overall approach of IFRS 11



Joint arrangement and joint control
i) Is there a contract?

contractual arrangements:

- Often, but not always, in writing
- Form of a contract or otherwise documented
- Statutory mechanisms
- Incorporated in the articles of association
- Set out terms.

Joint arrangement and joint control

ii) Is there a *joint control*?

- This is a key determination

- Joint control exists only when decisions about the **relevant activities** (i.e. those activities that impact the investors variable returns) require the **unanimous consent** of 2 or more parties, whether specifically stated or implied.

- Situations that do not result in joint control:
  - Where only a single party can control relevant activities (i.e. this would result in a parent and subsidiary)
  - Where unanimous consent is not required (i.e. taking all contractual agreements into consideration, there is more than one possible combination of parties that could make decisions about relevant activities
  - Where the decisions being made are not in relation to relevant activities and/or are protective in nature.

Joint arrangement and joint control

Examples

Assumptions:

- Assume there is a contractual agreement
- Assume that decisions are being made regarding relevant activities.
- Is there joint control , if yes between which parties and what is the reasoning?

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Parties and ownership	A - 50% B - 50%	A - 50% B - 30% C - 20%	A - 50% B - 25% C - 25%	A - 50% B - 25% C - 25%
Majority required	At least 51%	At least 75%	At least 75%	At least 75%
Other facts	N/A	N/A	N/A	A and B have a contractual agreement to always vote together

Joint de-facto control

What is joint de-facto control?

Need to consider the same factors as under IFRS 10 for *de-facto control*

- Size of the holding relative to the size and dispersion of other vote holders
- Potential voting rights
- Other contractual rights

As with *de-facto control*, ***joint*** *de-facto control* may exists where parties do not have a majority of the voting rights to make decisions regarding relevant activities.

In order to qualify for ***joint*** *de-facto control*, there must be a **contractual agreement** between the parties concerned to vote together.

- Past voting history showing consistent voting patterns is **not** sufficient to establish joint de-facto control under IFRS 11 (i.e. it is merely coincidence)

Joint de-facto control

Examples

Assumptions:

- Assume there is a contractual agreement
- Assume that decisions are being made regarding relevant activities.
- Is there de-facto control , if yes which parties and what is the reasoning?

	Scenario 1	Scenario 2	Scenario 3
Parties and ownership	A – 24% B – 24% Remaining 52% is dispersed	A – 24% B – 24% Remaining 52% is dispersed	A – 24% B – 24% C - 52% A and B **each** have substantive options to acquire 2% from C
Majority required	At least 51%	At least 51%	At least 51%
Other facts	N/A	A and B have a contractual agreement to always vote together	A and B have a contractual agreement to always vote together

Joint de-facto control

Examples - Solutions

	Scenario 1	Scenario 2	Scenario 3
Is there De-facto J/C?	N	Y	Y
If so, between which parties?		A &B	
Reasoning	No contractual agreement between A& B to vote together. There is no JC over the 48% block of shares	Contractual agreement between A &B to vote together. There is JC over 48% and the other 52% is widely dispersed.	As for scenario 2 and there are substantive voting options that would give A & B a majority of voting rights.

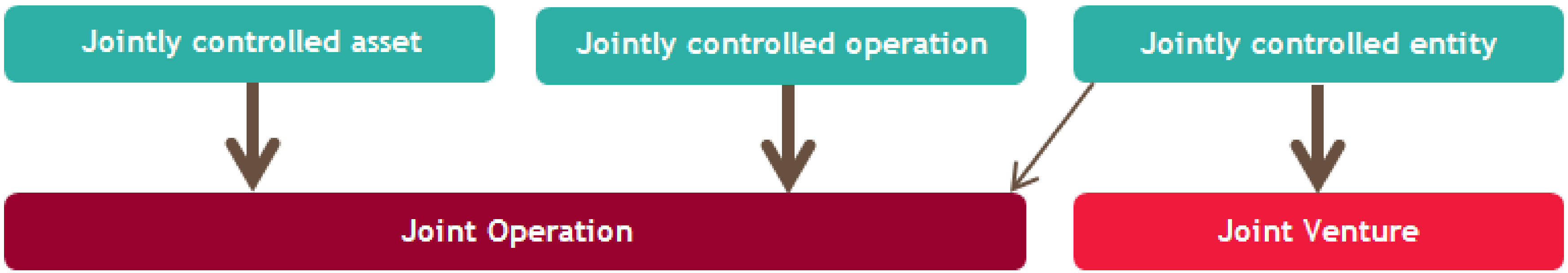
Classification of Joint Arrangements
Categories of Joint Arrangements

Under IFRS 11 there are 2 categories

- Joint operations
- Joint ventures

Under IAS 31 there were 3 categories

- Joint controlled asset
- Jointly controlled operation
- Jointly controlled entity



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Classification of Joint Arrangements
Effect of structuring through a separate vehicle

Separate vehicle established for the joint arrangement:

IAS 31	IFRS 11
Automatically classified as a *jointly controlled entity*.	Entity must assess the **<u>rights and the obligations</u>** of the parties arising from the arrangement in the normal course of business to determine classification.
Never classified as either a *jointly controlled asset or* a *jointly controlled operation*.	Therefore there is no automatic classification as a *joint venture*.
As a result, the structure (and not the substance) of the joint arrangement determines classification and subsequent accounting treatment.	**As a result, the substance (and not the structure) of the joint arrangement determines classification and subsequent accounting treatment.**

Classification of Joint Arrangements

Effect of structuring through a separate vehicle

Question: What exactly is a *separate vehicle*?

'A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality' (IFRS 11 appendix A)'

Which of these types of business structures would be considered a 'separate vehicle'

Structure	'Separate Vehicle' ? (Yes / No)
(a) Separate accounting records	(Yes) / (No)
(b) Separate bank account	(Yes) / (No)
(c) Circumscribed area of business	(Yes) / (No)
(d) Separate entity under statute/law	(Yes) / (No)
(e) An operating segment under IFRS 8	(Yes) / (No)

Classification of Joint Arrangements
Definition of categories under IFRS 11

Joint Operation

- Is a joint arrangement whereby the parties that have joint control of the arrangement **have rights to the assets, and obligations for the liabilities,** relating to the arrangement
- Parties are called 'joint operators'.

Joint Venture

- Is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the **net assets** of the arrangement
- Parties are called 'joint venturers'.

Classification of Joint Arrangements

Factors to consider - flow chart

Structured through a separate vehicles? — No → Joint operation

↓ Yes

Does the **legal form** give parties rights to assets and obligations for liabilities of the arrangement? — Yes → Joint operation

↓ No

Does the **contractual agreement** give parties rights to assets and obligations for liabilities of the arrangement ? — Yes → Joint operation

↓ No

Are there **other facts and circumstances** such as do the parties have rights to substantially all the economic benefits of the assets in the vehicle and does it depend on the parties on a continuous basis to settle its liabilities? — Yes → Joint operation

↓ No

Joint venture

Classification of Joint Arrangements

Structure

Joint arrangement structured through a separate vehicle?	
No	**Yes**
Classification • Joint operation	**Classification** • Joint operation, or • Joint venture ***Need to go on and apply the other tests in the previous flow chart (legal form, contractual agreement, and other circumstances) to determine classification.**

- This is one of the significant changes between IAS 31 and IFRS 11
- In practice separate vehicles will commonly be joint ventures, however entities still need to apply and analyse results of the other tests

Classification of Joint Arrangements
Legal form

- The classification of a joint arrangement as either a joint operation or joint venture hinges on whether the parties:
  - Have rights and obligations to assets and liabilities (joint operation)
  - Have rights to the net assets (joint venture)

- The legal form of the joint arrangement may provide further insight into to determining the rights of the parties.
  - However, an entity must still to go on and apply the other tests in the flow chart (contractual agreement, and other circumstances) to determine classification.
  - E.g. the legal form of the joint entity may legally give the parties rights over the net assets (i.e. most company structures), however, upon analysing the contractual agreement, and other circumstances, it may be found that the parties have rights and obligations to specific assets and liabilities.

Classification of Joint Arrangements

Legal form - rights and obligations

- In a straightforward joint venture involving a separate vehicle:
  - The separate vehicle has title to its own assets in its own right
  - Is responsible for settling its own liabilities in its own right.

- Note: the following would not change joint venture classification
  - The existence of guarantees provided by the joint venturers
  - Obligations for joint venturers to contribute unpaid capital
  - Obligations for joint venturers to contribute additional capital

Therefore, a joint operation rather than a joint venture will only exist where the parties, rather than the separate vehicle in its own right, have:

- Rights to the assets of the joint arrangement (e.g. title); AND
- Primary obligations to settle the liabilities of the joint arrangement with third parties

Classification of Joint Arrangements
Legal form - Unlimited Liability Vehicles

- Characteristics of unlimited liability vehicles (ULV):
  - Separate vehicle from a legal perspective
  - Parties have ultimate unlimited liability for any amounts owing that the separate vehicle cannot cover on its own.

- Is the ULV classified as a *Joint operation* or a *Joint venture*?

- Answer: *Joint venture*, because…
  - The ***primary responsibility*** for the ULV's liabilities rests with the ULV – the other parties (i.e. the joint venturers) responsibilities amount to a 'guarantee'
  - The joint venturers do not have rights to the ULV's assets – which is required for the classification as a *joint operation*.

Classification of Joint Arrangements
Legal form - Example 1: Construction Contract

- Parties A and B each provide many types of construction services
- A & B Enter into a contractual arrangement to design/build a road
- Parties set up a separate vehicle (entity Z)
  - Z enters into contract with government for the road
  - Assets and liabilities relating to the road contract are held in entity Z
- Main feature of Z's legal form is that the A & B have rights to the assets, and obligations for the liabilities, of the entity.
- A and B appoint an operator – an employee of one of the parties
- Entity Z invoices the government for the construction services
- Is it a joint venture or joint arrangement?

Note: Assume there are no other relevant facts and circumstances to consider in either the contractual arrangement or otherwise.

Classification of Joint Arrangements
Legal form - Example 1: Construction Contract

IAS 31	IFRS 11
Jointly controlled entity	**Joint operation**
• The joint arrangement is structured through a separate vehicle (default classification).	• The joint arrangement is structured through a separate vehicle, **<u>however</u>**, this does not confer separation between the parties and the separate vehicle. (i.e. A & B have rights to Z's assets and obligations for its liabilities).
Choice of *proportional consolidation* or *equity accounting*.	Recognise share of revenue, expenses, assets and liabilities.

Classification of Joint Arrangements

Legal form - Example 2: Real Estate

- Two real estate companies (the parties) set up a separate vehicle (entity X) for the purpose of acquiring and operating a shopping centre
- According to entity X's legal form it has rights to the assets, and obligations for the liabilities, relating to the arrangement
- Entity X owns the shopping centre
- Parties are not liable in respect of the individual debts, liabilities or obligations of entity X
- A & B receive a share of the income from operating the shopping centre.
- Is it a joint venture or joint operation?

Note: Assume there are no other relevant facts and circumstances to consider in either the contractual arrangement or otherwise.

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Classification of Joint Arrangements

Legal form - Example 2: Real Estate

IAS 31	IFRS 11
Jointly controlled entity	**Joint venture**
• The joint arrangement is structured through a separate vehicle (default classification).	• The joint arrangement is structured through a separate vehicle **<u>that does</u>** confer separation between the parties and the separate vehicle. (i.e. X has rights to its own assets and obligations for its own liabilities).
Choice of *proportional consolidation* or *equity accounting*.	*Equity accounting.*

Classification of Joint Arrangements
Contractual arrangement

Contractual arrangement often describes the nature of the activities and how the parties intend to undertake those activities together, and may include specific clauses in relation to:

- Development, manufacturing, and/or marketing activities to be undertaken
- How revenues and expenses are to be shared
- How to share and operate assets.

In the majority of cases the rights and obligations in the contractual arrangements are consistent, or do not conflict with, the legal form.

However, parties are able to use the contractual arrangement to reverse or modify the rights and obligations conferred by the legal form.

- It is therefore essential to analyse the specific details of the contractual arrangement between the parties to ensure appropriate classification and subsequent accounting treatment.

Classification of Joint Arrangements
Contractual arrangement - which category?

Joint operation classification arises only when the contractual arrangement specifies that, or results in a conclusion that, the parties have:

- Rights to assets, and
- Obligations for the liabilities.

Classification of Joint Arrangements

Contractual arrangement - Example 1: Oil and Gas

- Companies A and B (the parties) set up a separate vehicle (entity H) and Joint Operating Agreement (JOA) to undertake oil and gas exploration, development and production activities
- Shareholders' agreement and JOA establish rights and obligations
- Shareholders' agreement specifies:
  - Each party has a 50% interest in H and appoints one director
  - Unanimous consent required for all resolutions to be passed.
- The JOA specifies:
  - That the rights and obligations arising from the exploration, development and production activities shall be shared among the parties
- The costs incurred in relation to all the work programmes are covered by cash calls on the parties

Classification of Joint Arrangements
Contractual arrangement - Example 1: Oil and Gas

- JOA
  - Operating committee formed with one representative each from A and B
  - Operating committee approves budgets and work programmes – unanimous consent required
  - Rights and obligations arising from activities to be shared among the parties in proportion to their shareholding
  - Costs incurred in relation to all the work programmes are covered by cash calls on the parties
  - If either party defaults on its obligations, the other is required to contribute the default amount
  - Default amount becomes an amount owned by the defaulting party to the other.

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Classification of Joint Arrangements

Contractual arrangement - Example 1: Oil and Gas

IAS 31	IFRS 11
Jointly controlled entity	**Joint operation**
• The joint arrangement is structured through a separate vehicle (default classification).	• The joint arrangement is structured through a separate vehicle, **<u>however</u>**, the terms of the JOA result in A & B having rights to H's assets (i.e. permits, production etc.) and obligations for its liabilities (i.e. costs from work programmes).
Choice of *proportional consolidation* or *equity accounting*.	Recognise share of revenue, expenses, assets and liabilities.

Classification of Joint Arrangements
Other facts and circumstances

Even after considering:

- The **structure** of joint arrangement
- The **legal form** of a joint arrangement
- The **contractual agreement between the parties** of a joint arrangement

…an entity must still also consider **other facts and circumstances** that may result in the classification of a joint arrangement as a joint operation rather than as a joint venture

Classification of Joint Arrangements
Other facts and circumstances - what exactly?

The types of other facts and circumstances to consider are those that:

- Result in the parties having rights to substantially all of the economic benefits relating to the arrangement
- Result in the arrangement being dependent on the parties on a continuous basis in order to settle its liabilities.

For example, in the instances where a joint arrangement established between two parties where the output is produced for and sold to the parties exclusively (either contractually or due to specific purpose):

- The parties have the benefit of the output produced from the arrangement
- The settlement of the arrangements liabilities is dependent on the parties purchasing the output from the arrangement (as they are unable to sell it to third parties) – i.e. the parties are the only source of cash inflow for the arrangement.

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Classification of Joint Arrangements
Other facts and circumstances - Example 1

- A and B (the parties) set up a framework agreement for the manufacturing and distribution of a product (product K)
- Two joint arrangements:
  - One to manufacture K
  - One for distribution activities relating to K
- Both joint arrangements operate through separate vehicles
- Legal form causes the separate vehicles to have rights to assets and obligations for liabilities in their own right
- None of the framework, manufacturing or distribution agreements specify that A and B have rights to assets and obligations for the liabilities of the manufacturing or the distribution activity

Classification of Joint Arrangements
Other facts and circumstances - Example 1

- Manufacturing agreement – key aspects
  - A and B commit to purchase entire production in proportion to shareholdings
  - Production then sold to distribution joint arrangement
  - All output of manufacturing agreement is sold to A and B at a defined price
- Distribution agreement – key aspects
  - Orders product P according to its requirements in the markets where the product is sold
- Framework agreement
  - Manufacturing arrangement is production level based on distribution requirements
  - Sales price from manufacturing arrangement will cover all costs incurred
  - A and B will sell to distribution arrangement at a mutually agreed price
  - A and B will finance any cash shortfall of the manufacturing agreement in proportion to their interests

Classification of Joint Arrangements
Other facts and circumstances - Example 1

IAS 31 (Manufacture and Distribution)	IFRS 11 (Manufacture)	IFRS 11 (Distribution)
Jointly controlled entity	**Joint operation**	**Joint venture**
• The joint arrangement is structured through a separate vehicle (default classification).	• A and B committed themselves to purchasing the whole production commitments to provide funds rights to substantially all the economic benefits	• The joint arrangement is structured through a separate vehicle **<u>that does</u>** confer separation between the parties and the separate vehicle.
Choice of *proportional consolidation* or *equity accounting*.	Recognise share of revenue, expenses, assets and liabilities.	*Equity accounting*.

6) Transition - Consolidated financial statements

Transition

Date of initial application

The beginning of the annual reporting period for which IFRS 11 is applied for the first time.

It is not the beginning of the comparative period.

E.g. If an entity has a 31 December year end, and adopts IFRS 11 as required on **1 January 2013**

- Date of initial application is **1 January 2013**, not the beginning of the comparative period (i.e. 1 January 2012)

This is important as transition requirements focus on the position as at the *date of transition*.

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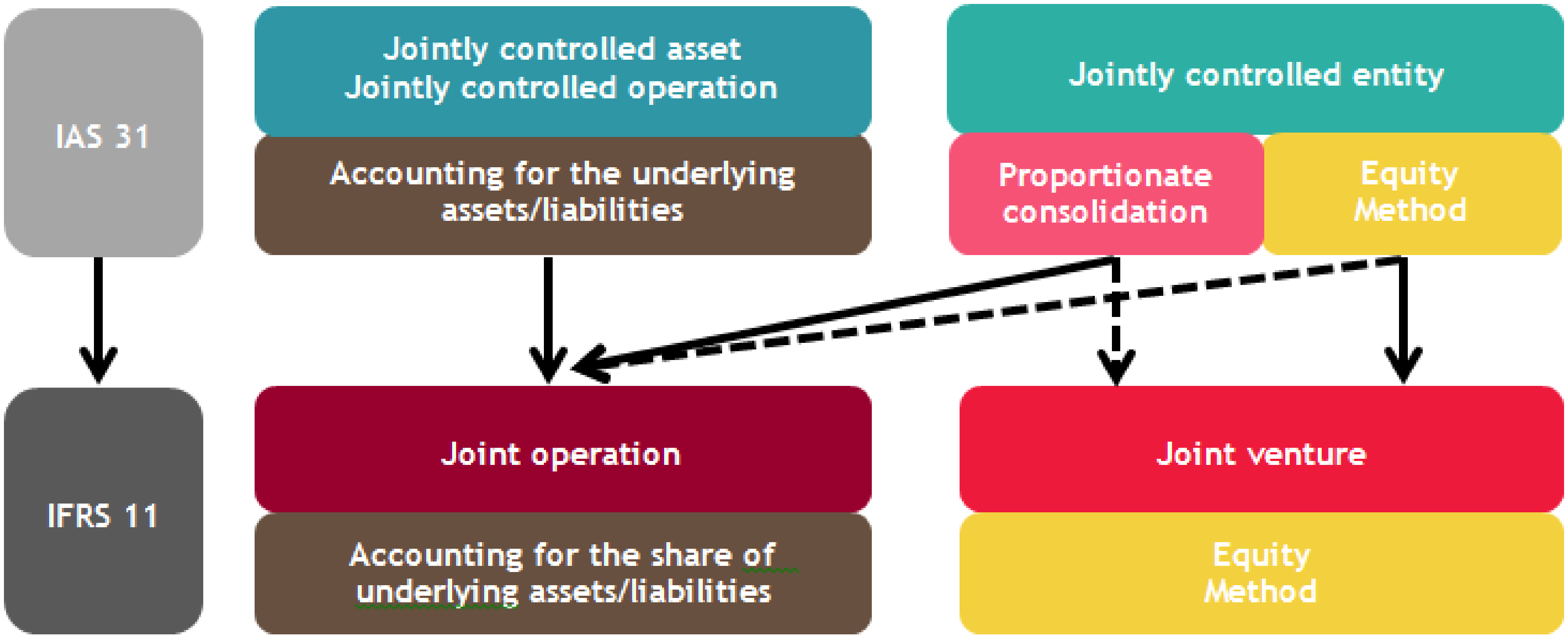
Transition - Consolidated financial statements
Other points to note

- No specific transitional requirements provided in moving to the equity method under IAS 28(2011)

- Therefore IAS 8 applies: retrospective application, from the earliest period presented from which it is practicable.

Transition - Consolidated financial statements
Possible transition scenarios



- *Dashed arrows* indicate potential significant transition considerations

Transition - Consolidated financial statements
Previous *jointly controlled entities*

IAS 31 (Classification)	IFRS 11 (Classification)	
	Joint Operation	Joint Venture
Jointly controlled entity *(Equity accounting)*	Equity accounting will need to be discontinued. Retrospective adjustments will be required.	No change to subsequent measurement.
Jointly controlled entity *(Proportionate consolidation)*	No change to subsequent measurement. Entity will still be recognising its share [proportion] of assets, liabilities, expenses, and revenue.	Proportionate consolidation is not available under IFRS 11. Retrospective adjustments will be required.

- There will be a significant change on transition for joint arrangements:
  - Previously equity accounted *JCE's*, that become *joint operations*
  - Previously proportionately consolidated accounted *JCE's*, that remain *joint ventures*.

Transition - Consolidated financial statements
i) From equity method to share of assets and liabilities

Steps upon transition:

a) Derecognise the equity accounted investment (X)
b) Determine the initial carrying amount of the assets and liabilities (based on their carrying amounts used in previously applying the equity method)
c) Recognise the share of each of the assets and the liabilities in the joint operation **(Y)**
d) Account for any difference between (X) and **(Y)** as follows:
   - If **(Y)** > (X): Difference first goes against goodwill, then any residual to opening retained earnings
   - If (X) > **(Y)**: Difference taken against opening retained earnings.
e) Disclose reconciliation: Between equity method and line-by-line net assets

Other points to note:

- **Deferred tax**: the initial recognition exemption does not apply.

Transition - Consolidated financial statements
ii) From proportionate consolidation to equity method

Steps upon transition:

a) Calculate the deemed-cost of the investment at transition, being the aggregate of all previously proportionately consolidated assets and liabilities (including any goodwill)
b) Determine if there is any impairment to be recognised, and if so, take as an adjustment to opening retained earnings
c) Disclose, in aggregate, a breakdown of the assets and liabilities that comprise the investment in the joint ventures affected.

Other points to note:

- **Goodwill**: If allocated to larger CGU(s), apportion based on relative carrying values
- **Negative aggregated net assets (from step 1 above)**:
  - Recognise a liability **if, and only if**, there is a legal or constructive obligation
  - Otherwise, take to retained earnings.
- **Deferred tax**: the initial recognition exemption does not apply

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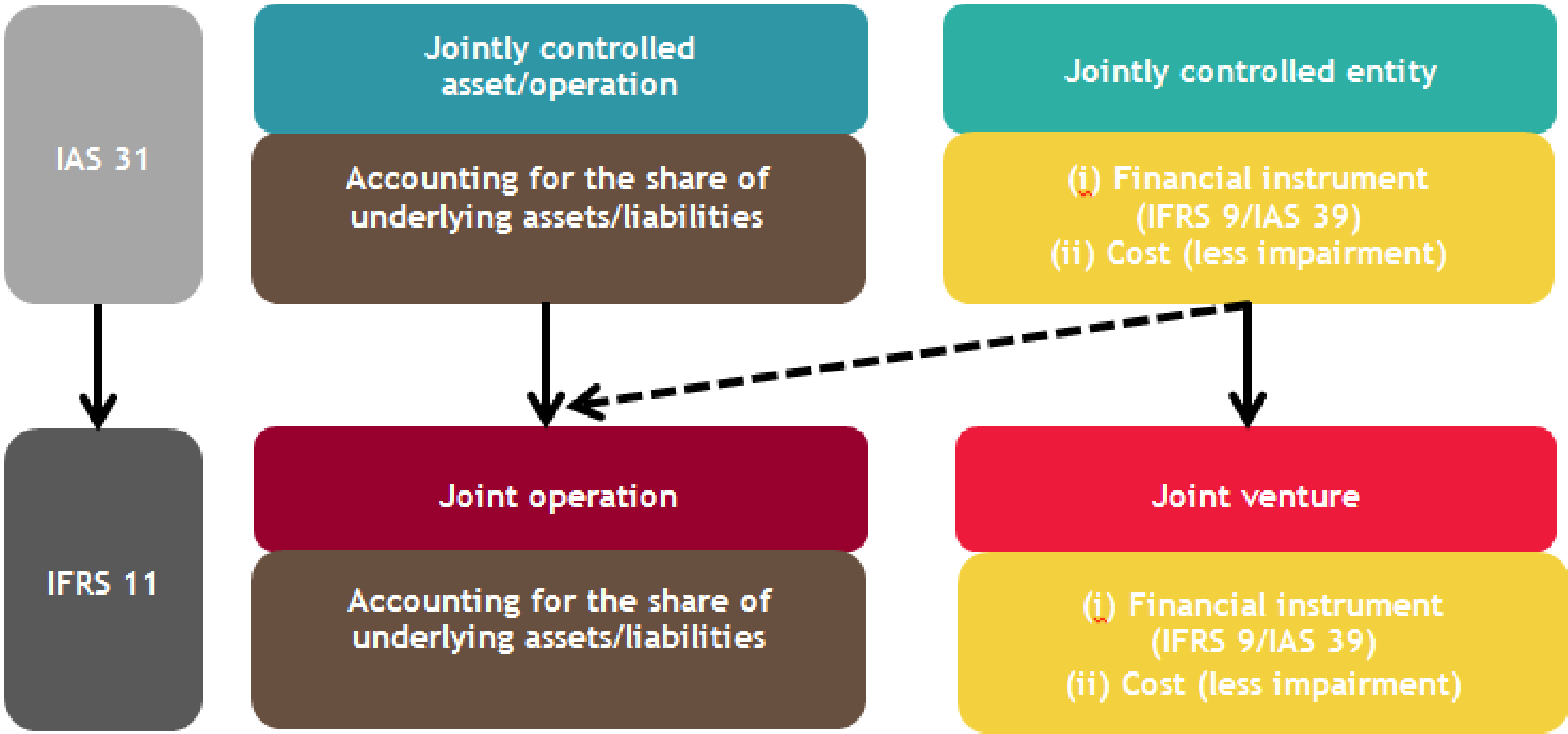
Transition - Separate financial statements
Possible transition scenarios



- *Dashed arrows* indicate potential significant transition considerations

Transition - Separate financial statements
From cost to share of assets and liabilities

Steps upon transition:

a) Derecognise the carrying amount of the investment (X)
b) Determine the initial carrying amount of the assets and liabilities
c) Recognise the share of each of the assets and the liabilities in the joint operation **(Y)**
d) Take any difference between (X) and **(Y)** to retained earnings
e) Disclose reconciliation: Between previous investment and line-by-line net assets.

Other points to note:

- **Deferred tax**: the initial recognition exemption does not apply.

Other parties to as joint arrangement
Introduction

IFRS 11 only applies to parties to a joint arrangement

Any other parties who are not joint controlling parties must look to other IFRSs in order to determine how to account for their interest in the arrangement.

The next slide addresses the treatment when the arrangement has been structured through a **separate vehicle** (that the party holds and interest in).

Other parties to a joint arrangement
Arrangements structured through a separate vehicle

Treatment by the other party will depend on whether the party holds ***significant influence:***

Consolidated/Individual financial statements		Separate financial statements		
Assess for significant influence		Assess for significant influence:		
If present	If not present	If present - choose either		If not present
Equity account (IAS 28)	Financial Instrument (IFRS 9/IAS 39)	Cost (Less impairment)	Financial instrument (IFRS 9/IAS 39)	Financial instrument (IFRS 9/IAS 39)

Action required
Re-assess joint arrangements

- Management judgement required
  - At transition
  - Recurring
- Consider all facts and circumstances
- Limited time to change existing arrangements
  - Transition date was 1 January 2013
- Communicate to shareholders
- Manage analysts expectations
- Equity accounting could lead to significant changes in financial statements and ratios

Action required
Analyse existing contracts

- Remuneration agreements (incl. IFRS 2)
- Contingent consideration (IFRS 3)
- Debt covenants
- Performance measures

IFRS 11: *Joint Arrangements*

Thank You: End of Presentation