Practical guide to IFRS

New guidance on accounting for joint arrangements – a significant issue for the Oil & Gas sector

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Contents

A new standard on accounting for joint arrangements was issued in May 2011. It is mandatory from 1 January 2013 but it can be early adopted now provided IFRS 10, IFRS 12, IAS 27 (revised) and IAS 28 (revised) are also adopted.

PwC's practical guide 'Joint arrangements: a new approach to an age-old business issue' provides a comprehensive analysis of the new standard. This document considers issues specific to the Oil & Gas industry.

What is the issue?

The Oil & Gas industry is distinguished by being high risk, with most costs incurred before there are proven quantities of natural resources. The value extracted from the resources is vulnerable to broader economic, political and regulatory forces: it is exposed to commodity and currency prices, the insatiable desire of governments for tax revenues and increasingly punitive taxes designed to reduce carbon footprints, among other influences. It is therefore no surprise to find otherwise fierce competitors engaged in a variety of joint working arrangements designed to reduce risk, share capital-intensive infrastructure and reach otherwise protected markets.

The industry will be significantly impacted by IFRS 11, 'Joint arrangements'. This is the first significant overhaul of accounting for joint activities under IFRS since IAS 31, 'Interests in joint ventures', was published in 1990. Much of the practice around accounting for joint arrangements under predecessor GAAPs and then on transition to IFRS was driven by practice under US GAAP or the UK SORP.

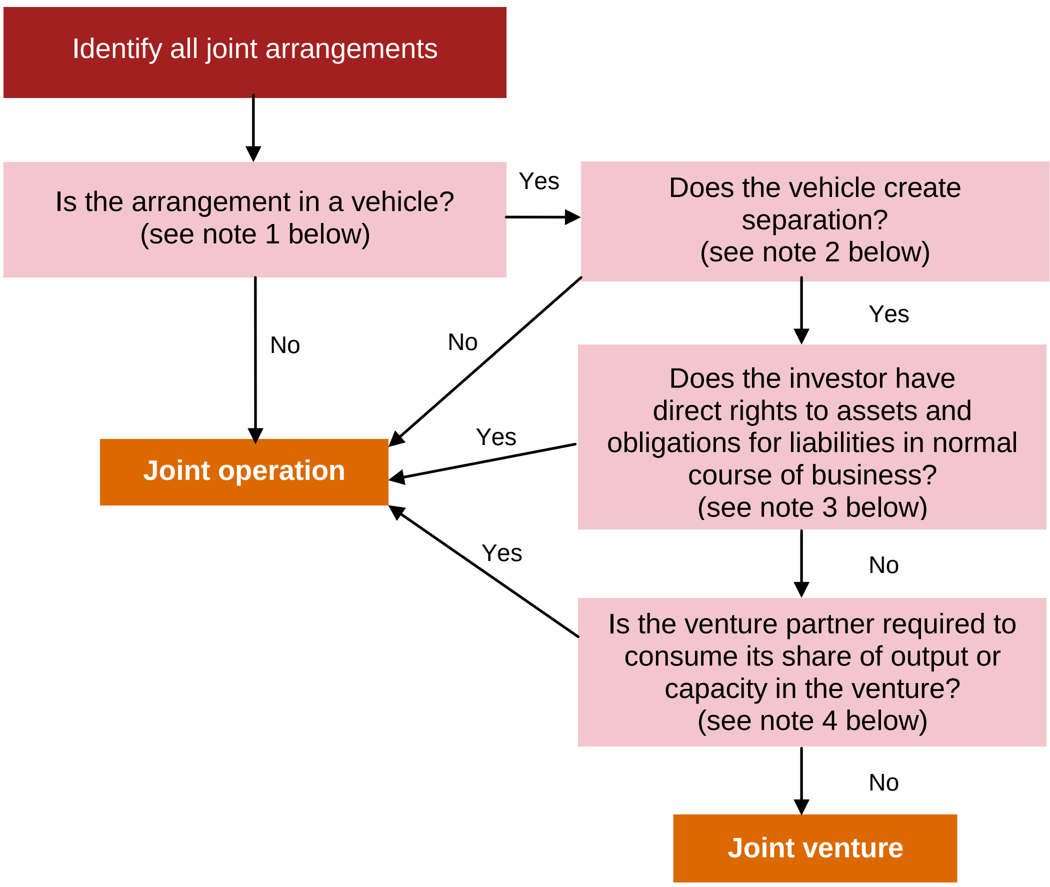
Venture partners accounted for an undivided working interest in upstream activities by reflecting their direct interest in assets and liabilities and their share of revenue and costs. The increasing risks and complexity of upstream operations has resulted in more joint arrangements being structured through legal entities. Midstream and downstream joint working arrangements are also often separate legal entities, particularly where the venture partners were seeking to limit their potential liability to prospective creditors and other obligations such as decommissioning. Venturers frequently accounted for their interest in incorporated joint ventures using equity accounting. IAS 31 allowed a policy choice for accounting for incorporated entities. Most Oil & Gas entities on transition to IFRS continued their existing practices, following a form of proportionate consolidation for upstream activities and equity accounting for midstream and downstream incorporated entities.

Determination of the type of joint arrangement is the complex decision under IFRS 11; from that point, there are no accounting options available. There are two types of joint arrangement under IFRS 11: joint operations and joint ventures. A venturer accounts for its interest in a joint operation as its share of assets, liabilities, revenue and costs. A joint venture is accounted for under IAS 28, 'Equity accounting'.

Legal form remains relevant for determining the type of joint arrangement but is less important than under the previous standard. A joint arrangement that is not structured through a separate vehicle is a joint operation. However, all joint arrangements in separate vehicles are not automatically joint ventures. A joint arrangement in a separate vehicle can still be a joint operation; it depends on the rights and obligations of the venturers arising from the arrangement in the normal course of business and is further influenced by the economic purpose of the joint arrangement.

The flowchart below illustrates the decision-making process and what needs to be considered to properly classify joint arrangements as operations or ventures.

Classification of joint arrangements



Notes to flowchart

1. There are many different types of vehicle used for joint arrangements in the Oil & Gas sector, including partnerships, unincorporated entities, limited companies and unlimited liability companies. Venturers will have to assess all their joint arrangements and identify those that are operated through vehicles. Joint arrangements that are not operated through a separate vehicle are joint operations.

2. The legal structure of the vehicle or the contractual terms between the venturers may not provide for legal separation of the venture from the venture partners – that is, the venturers remain exposed to direct interest in the assets and liabilities of the venture. General partnerships, for example, may not create separation from the partners because the contractual terms provide direct rights to assets and expose the partners to direct obligations for liabilities of the partnership in the normal course of business. Similarly, unlimited liability entities provide direct rights and obligations to the venture partners. Joint arrangements conducted in vehicles that do not create separation are joint operations.

3. The parties' rights and obligations arising from the arrangement are assessed as they exist in the 'normal course of business' (IFRS 11 para B14). Legal rights and obligations arising in circumstances that are other than in the 'normal course of business', such as liquidation and bankruptcy, are therefore much less relevant. A separate vehicle may give the venture partners rights to assets and obligations to liabilities as per the terms of their agreement. However, in case of liquidation of the vehicle, secured creditors have the first right to the assets and the venture partners only have rights in the net assets remaining after settling all third-party obligations. The vehicle could still be classified as a joint operation as, in the 'normal course of business', the venture partners have direct interest in assets and liabilities. The impact of the concept of 'normal course of business' is not fully understood yet. For example, if the 'ratchet' terms form part of the contractual agreement and the parties' share of the output of assets varies over the period of the arrangement, it is not clear how the venturers would account for this. Separate vehicles that give venture partners direct rights to assets and obligation for liabilities of the vehicle are joint operations.

4. Separate vehicles structured such that all of their outputs must be purchased or used by the venture partners may also be joint operations. However, the contractual terms and legal structure of the vehicle need to be carefully assessed. There must be a contractual agreement or commitment between the venture parties that requires the parties to purchase or use their share of the output or capacity in the venture. If the venture can sell the output to third parties at market prices, this criteria is unlikely to be met.

The views expressed above are as a result of our initial reading of the new standard. Practice may evolve and change as the standard is applied and accounting regulators make their views known.

Which entities in the Oil & Gas sector might be most impacted?

Entities in the Oil & Gas sector that are likely to be most significantly impacted include those that:

- participate in a significant number of joint arrangements;
- enter into new joint arrangements;
- currently apply proportionate consolidation for jointly controlled entities;
- currently apply the equity method to jointly controlled entities that are assessed to be joint operations under IFRS 11; and
- have old joint arrangements with limited documentation detailing the terms of the arrangement.

Three key areas of focus under the new standard

1. Classification	
Key change (snapshot)	**Impact on IFRS financial statement**
The accounting will no longer be driven solely by the legal form of the arrangement. Instead, entities have to assess their rights and obligations under the joint arrangement to determine the appropriate classification as either a 'joint operation' or 'joint venture'. Classification now determines the accounting.	A joint operation gives parties to the arrangement direct rights to benefit from the assets and obligations for the liabilities. A joint operator will recognise its interest based on its involvement in the joint operation (that is, based on its direct rights and obligations) rather than on the participation interest it has in the joint arrangement. A joint venture, in contrast, gives the parties rights to the net assets or outcome of the arrangement. A joint venturer does not have rights to individual assets or obligations for individual liabilities of the joint venture. Joint ventures are accounted for using the equity method in accordance with IAS 28, 'Investments in associates and joint ventures'.
Industry impact Upstream joint working arrangements use both forms of joint arrangement but do not commonly operate through separate vehicles. Such arrangements are generally classified as jointly controlled assets or jointly controlled operations under the current IAS 31 and would be joint operations under IFRS 11. In most cases, investors would continue to account for their share of assets and liabilities and would not be impacted by IFRS 11. Midstream and downstream joint working arrangements generally operate through separate vehicles and incorporated entities. Assessing whether such arrangements are joint ventures or joint operations will pose challenges to the venturers. This challenge will also be true for those upstream joint arrangements that operate through separate vehicles.	
2. No proportionate consolidation	
Key change (snapshot)	**Impact on IFRS financial statement**
The standard requires joint ventures to be accounted for using the equity method. Previously, a venturer could choose to proportionately consolidate their ownership interest in the joint controlled entity.	Equity accounting will apply to all joint ventures. A single line item will be shown in the consolidated income statement to reflect the share of profit or loss in the joint venture; a single line item would be shown in the consolidated balance sheet to reflect the share of net assets in the joint venture.
Industry impact Arrangements that were previously jointly controlled assets or jointly controlled operations and are now classified as joint operations will not be impacted by this change. Many upstream joint arrangements are unlikely to see a major change in their accounting. However, midstream and downstream activities conducted through a jointly controlled entity where the participants chose	

proportionate consolidation under IAS 31 will see a major change if the arrangement is assessed as a joint venture under IFRS 11. As assets, liabilities, income and expenses would no longer be proportionately consolidated, it will have a fundamental impact on the landscape of each party's financial statements and may even impact loan covenants such as those based on asset ratios and EBITDA, depending on how they are defined by the party. Staff of the IFRS Foundation have issued an 'effect analysis' which commented '…energy is one of the industries where we found more examples of arrangements structured in separate vehicles that can be considered in their own right that will, however, be classified as joint operations.'

3. Transition – may not be easy

Key change (snapshot)	Impact on IFRS financial statement
Entities should re-evaluate the terms of their existing contractual arrangement to ensure that their involvements in joint arrangements are correctly accounted for under the new standard. Joint arrangements that were previously accounted for as joint operations may need to be treated as joint ventures, or vice versa, on transition to the new standard.	When transitioning from the proportionate consolidation method to the equity method, entities should recognise their initial investment in the joint venture as the aggregate of the carrying amounts that were previously proportionately consolidated. To transition from the equity method to proportionate consolidation, entities will derecognise their investment in the jointly controlled entity and recognise their rights and obligations to the assets and liabilities of the joint operation. Their interest in those assets and liabilities may be different from their equity method investment. These transition provisions would be applied as at the beginning of the earliest period presented.

Industry impact

Moving from the equity method to share of assets and liabilities will not always be a simple process. For example, parties may have contributed specific assets to a joint arrangement. When evaluating interest based on share of assets and liabilities, parties will account for their interest in the arrangement based on the share of assets contributed by them. The interest calculated based on assets contributed will not necessarily result in the same interest that the party may have in the equity of that entity. For example, the party may have a 30% interest in the equity of an entity but may have a right to 100% of a particular asset. On transition, any difference arising between the net amount of assets and liabilities (including goodwill) recognised and the investment previously equity accounted is adjusted against the retained earnings at the beginning of the earliest period presented. Where the net amount of assets and liabilities are higher than the investment value, the difference is first offset against any goodwill relating to the investment, and any remaining difference is adjusted against retained earnings.

Similarly, moving from proportionate consolidation to equity method could pose challenges. For example, the liabilities of a joint arrangement assessed to be a joint venture may exceed the assets. Netting these may result in the venturers' investment becoming negative. The venturers will then have to assess whether they need to record a liability in respect of that negative balance. This will depend on whether the venturer has an obligation to fund the liabilities of the joint arrangement. If it does, it might raise a question on whether the arrangement was correctly assessed to be a joint venture instead of a joint operation.

Transition provisions on adoption of IFRS 11 are not expected to have any impact on the income statement of entities.

Following transition, if there is a change in the contractual terms or any other facts and circumstances between venturers, the venture partners should reassess whether the type of joint arrangement in which they are involved has changed.

Examples: an illustration of the key impacts in the Oil & Gas sector

Example 1 – Joint control

Two companies, A and B, set up a partnership and sign a joint operating agreement. The board contains three directors from each company and is the main decision-making body of the company. Decisions are made by simple majority. Each party has a 50% interest in the net profit generated. Is there joint control?

Preliminary conclusion: More information and analysis needed.

It may appear that A and B have joint control because each party has a 50% interest in net profit and both have a right to appoint three directors, but this cannot be automatically assumed. As decision-making is by simple majority, it is possible that one director of shareholder A agrees with three directors of shareholder B and takes a decision that is against the interest of shareholder A. In such a case, there would not be joint control, as decisions are made without unanimous consent. However, if the three directors representing a single shareholder are required to vote as a group per the directions of the shareholder, unanimous consent would be required for decision-making – this would represent joint control. All relevant facts and circumstances have to be considered before reaching a conclusion.

Example 2 – Classification

Two parties, A and B, form a limited company to build and use a pipeline to transport gas. Each party holds a 50% interest in the company. As per their contractual terms, A must use 45% of the pipeline capacity, and B must use the remaining pipeline capacity of 55%. Neither A or B can sell their share of the capacity to a third party without prior consent of other party. The price paid by A or B for the gas transport is determined in a manner to ensure recovery of all costs incurred by the company. Is the limited company a joint operation or a joint venture?

Preliminary conclusion: Joint operation.

The joint arrangement is structured through a separate vehicle, and both parties have a 50% interest in the company. However, the contractual terms require a specific level of usage by each party, and because of the pricing structure, the entities have a deemed obligation for the company's liabilities. The entity may be a joint operation despite the legal form of the arrangement.

Secured and other creditors will have the first right on the assets of the company in case of liquidation or bankruptcy. A and B will only have a share in the residual net assets remaining after all claims have been settled. However, as this will not arise in the ordinary course of business, this aspect is less relevant when determining the classification of the joint arrangement.

Example 3 – Classification

Entities A and B form a partnership vehicle to own and operate a crude oil refinery. The output of the refinery is sold to third parties at market prices. Neither party has an obligation to buy the output from the refinery. Each party has a 50% interest in the net profits of the partnership. Is this a joint operation or a joint venture?

Preliminary conclusion: More information and analysis needed.

The joint arrangement is structured through a vehicle, and the venture parties have 50% interest in the net profits of the partnership; so this appears to be a joint venture. However, an evaluation is required as to whether the partnership creates separation. Sometimes general partnerships do not create separation; that is, parties to the partnership may have a direct interest in the assets and liabilities of the partnership. The terms of the partnership agreement must therefore be evaluated to assess the rights and obligations of each party.

If there is separation, it is likely that this will be a joint venture. There is no obligation for the parties to take the output of the refinery and they do not have an obligation to fund the settlement for its liabilities.

Example 4 – Presentation

Entities A and B formed a jointly controlled entity. This represents a significant portion of A's business. Under IAS 31, entity A adopted a policy of proportionate consolidation. Approximately 70% of A's revenue arises from the joint arrangement. The arrangement is concluded to be a joint venture under IFRS 11. Entity A will have to apply equity accounting. Can A include its share of profit/loss of the joint venture under equity accounting within its operating profit?

Preliminary conclusion: Yes, in circumstances where a significant part of the investor's business is performed through a joint venture, it can present the share of profit/loss from joint venture before the operating profit.

IAS 1, 'Presentation of financial statements', specifies the line items that, as a minimum, should be presented in the income statement. In this list, investors' share of profits or losses from joint ventures comes after the line item for finance costs but before the line item for tax expense. The share of profits/losses of a joint venture is therefore usually presented between finance costs and income tax expense.

However, where joint ventures are so significant that they are regarded as a primary vehicle for the conduct of the group's operations, it may be appropriate in some circumstances to include the share of profits/losses in arriving at operating profit.

What are the potential business impacts for the Oil & Gas sector?

- Changes to the classification of joint arrangements may result in significant financial changes. This could impact the recognised amounts in profit and loss (for example, revenues and expenses), the balance sheet presentation and the supplemental information presented in the financial statements (for example, disclosure of reserves). Leverage, capital ratios, management incentives, covenants and financing agreements may be affected as a result of these changes. Many entities in the Oil & Gas sector focus on EBITDA measures and revenue. The changes will impact these measures, and some entities may choose to adjust their reporting.

- Entities should consider how to communicate the impacts of the accounting changes to their shareholders and other stakeholders. There could be important changes to the manner in which the entity's interest in the joint arrangement is reported and understood by users of the financial statements.

- Structuring of future deals should be considered with the new rules in mind. For example, a joint arrangement involving the establishment of a new entity would not necessarily give rise to a joint venture, but the specific terms of the arrangement would still need to be analysed in order to understand the entity's rights and obligations under the agreement.

- Entities may need to request more detailed financial reporting information from an operator of a joint operation if they move from equity accounting to the share of assets and liabilities approach. Similarly, they may need to provide more detailed information to other parties if they are the operator of a joint operation. For example, an operator may need to provide information concerning the maturity profile of financial liabilities to allow appropriate classification on the balance sheet of the venturer or to understand the assumptions utilised in measuring decommissioning cost estimates. Operators may also be required to provide this information at numerous points during a reporting cycle, as venturers may have different reporting dates. Entities that operate significant business through joint arrangements may consider renegotiating the existing arrangements and restructuring the operations to be able to meet the definition of a joint operation. This will allow them to account for a share of assets, liabilities, income and expenses rather than a share of profit/loss.

- In some countries, non-domestic operators are obliged to have a local partner. It can be challenging to obtain detailed financial information on a timely basis from these businesses, and moving from equity accounting to share of assets/liabilities could be difficult. Similarly, entities may have production-sharing agreements with governments. If these are assessed as joint operations and the entities have to record their share of production, assets and liabilities, it may be a challenge to access all the financial information from the government agencies on a timely basis.

- The standard does not contain the guidance on specific industry issues such as farm-outs and unitisation that was published in the exposure draft. Entities therefore need to consider the requirements of other applicable standards and the Framework when developing accounting policies for these transactions.

- Initial transition requirements and annual reassessment of arrangement terms may require changes to existing processes and internal controls. Gathering and analysing the information could take considerable time and effort depending on the number of arrangements in place, the inception dates and the records available. Early assessment and management of all the potential implementation and ongoing business impacts of IFRS 11 will help reduce unexpected business and reporting risks.