Applying IFRS in Power & Utilities

IFRS 11 *Joint Arrangements*

Accounting for joint arrangements in the power and utilities sector

Challenges in applying IFRS 11

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Ernst & Young
Quality In Everything We Do

Impact of IFRS 11 on the power and utilities sector

In the face of increased market volatility, entities in the power and utilities sector are continually searching for ways to diversify their risk and manage the significant costs involved in construction. This effort manifests itself in bringing in partners to construct new, or upgrade existing, facilities, improve utilisation of expensive infrastructure, help manage technical or social risk in certain jurisdictions or to comply with local regulations. As a result, joint arrangements have always been and continue to be a common structure in achieving these goals for the power and utilities sector.

This publication is designed to assist in understanding the implications the new accounting standard for joint arrangements will have on the power and utilities sector. For some joint arrangements, the accounting is about to significantly change — particularly for entities that applied proportionate consolidation accounting to jointly controlled entities that meet the definition of joint ventures under the new standard. In addition, not all arrangements that are currently described as 'joint ventures' or 'joint arrangements' will meet the new definition of a joint arrangement. As a result, careful assessment of the structure and legal form of the arrangement, the contractual terms agreed by the parties to the arrangement and other facts and circumstances will be required.

What's the impact?

- A confusing part of the changes is the use of terminology that is common in practice versus within the new accounting standard. The way in which a number of common terms are defined in IFRS 11 may not be obvious.
- Some proportionately consolidated jointly controlled entities (JCEs) may be classified as joint ventures under IFRS 11 and will have to be accounted for using the equity method.
- Conversely, some JCEs that entities have elected to account for using the equity method may be classified as joint operations and an entity will need to recognise its assets, liabilities, revenues and expenses and/or its relative share of jointly held assets, jointly incurred liabilities and revenue/expenses which were jointly produced/incurred.
- These changes will impact the presentation of financial statements and, in some instances, there may also be measurement differences which will affect profit or loss and/or net assets.
- Accounting and consolidation systems, business processes and controls may need to be updated. Other areas of a business may be impacted, such as loan covenants and remuneration structure.

What you need to know

- The International Accounting Standards Board (IASB) issued the following standards in 2011:
  - IFRS 10 *Consolidated Financial Statements* — includes a new definition of control and has additional requirements that could impact any previous assessment of control versus joint control
  - IFRS 11 *Joint Arrangements* — describes the accounting for arrangements in which there is joint control; proportionate consolidation is not permitted for joint ventures (as newly defined)
  - IFRS 12 *Disclosures of Interest in Other Entities* — requires new and expanded disclosures for joint arrangements, as well as for subsidiaries, associates and structured entities, which will impact processes and systems
- These new standards are effective for annual periods beginning on or after 1 January 2013 and must be applied retrospectively. Early adoption of IFRS 11 is permitted provided that an entity also applies the requirements of IFRS 10, IFRS 12, IAS 27 (as revised in 2011) and IAS 28 (as revised in 2011) at the same time
- Significantly more judgement is required to apply the new standards

Contents

Additional materials

This publication focuses on the implications specific to the power and utilities sector. For a more complete summary of IFRS 10, IFRS 11 and IFRS 12, and the impacts on your business, refer to:

- *IFRS Developments – IASB issues three new standards: Consolidated Financial Statements, Joint Arrangements, and Disclosure of Interests in Other Entities*, Issue 1 (May 2011)
- *IFRS Practical Matters – What do the new consolidation, joint arrangements and disclosures accounting standards mean to you?* (June 2011).
- *Applying IFRS – Challenges in adopting and applying IFRS 10* (September 2011)
- *Applying IFRS – Challenges in adopting and applying IFRS 11* (September 2011)

These publications are available at www.ey.com/IFRS.

1. Overview

The accounting for interests in joint ventures and alliances governed through joint control was previously addressed in IAS 31 *Interests in Joint Ventures* and was linked to the structure of the arrangement. When the joint venture was structured in a separate entity, IAS 31 allowed an accounting choice — apply the equity method or proportionate consolidation.

IFRS 11 establishes a principle-based approach for the accounting for joint arrangements, in which the parties recognise their rights and obligations arising from the arrangements. In issuing the new standard, the IASB believes that the recognition of rights and obligations ensures that the accounting for joint arrangements captures the economic substance of the arrangements, thereby providing consistency in the accounting and resulting in enhanced comparability of financial statements.

IFRS 11 prescribes the accounting for a 'joint arrangement', which is defined as a contractual arrangement over which two or more parties have joint control. Because IFRS 10 has revised the definition of 'control' that will be used in assessing 'joint control' under IFRS 11, it is important that entities understand the implications and interplay of both IFRS 10 and IFRS 11 to ensure the proper evaluation of and accounting for joint arrangements.

The adoption of IFRS 11, which is required for annual periods beginning on or after 1 January 2013, may have little or no impact on a number of joint arrangements. This is because numerous joint arrangements are established through agreements that do not involve a separate entity. As a result, entities with joint arrangements that do not involve a separate vehicle will continue to recognise assets, liabilities, revenues and expenses as they had under IAS 31.

The most significant change will occur for companies that previously elected the option to apply proportionate consolidation to investments in a jointly controlled entity. Only some, but not all, joint arrangements structured through separate vehicles will be joint ventures under IFRS 11. Parties to those arrangements will have an interest in the joint venture's net assets and will account for it using the equity method.

2. Clarifying the confusion ... new terms, new concepts

IFRS 11 has taken some commonly used terms and given them new meanings. For example, what many in the sector previously referred to as joint ventures will be collectively referred to as 'joint arrangements' and the term 'joint venture' is narrowly defined in IFRS 11.

Likewise, the term 'proportionate consolidation' has been (and still is) used to casually describe all methods of accounting where an entity recognises its share of the assets and liabilities of the joint venture. However, from an accounting perspective, this term means something quite specific. It is not the accounting applied to jointly controlled assets (JCAs) and jointly controlled operations (JCOs) under IAS 31. Under IFRS 11, an entity with an interest in a joint operation will recognise its assets, liabilities, revenue and expenses and/or its share of assets, liabilities, revenue and expenses incurred jointly, which may be similar to, but not the same as, proportionate consolidation.

As such, the impact of the new standard may be significant due to the changes in definitions, the modifications to the accounting method applied to joint operations and the accounting for joint ventures under the equity method.

Many read the headline "proportionate consolidation is no longer permitted for joint ventures" and interpret this to mean that all interests in joint arrangements must now be accounted for using the equity method, which is incorrect.

3. New definition of joint control

Since the critical element of having a joint arrangement is joint control, it is important to understand the definition of this term. Joint control is defined as "the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control." An entity that is a party to an arrangement has to assess whether the contractual arrangement gives all the parties, or a group of the parties, control of the arrangement collectively. All the parties, or a group of the parties, control the arrangement collectively when they must act together to direct the activities that significantly affect the returns of the arrangement (i.e., the relevant activities).

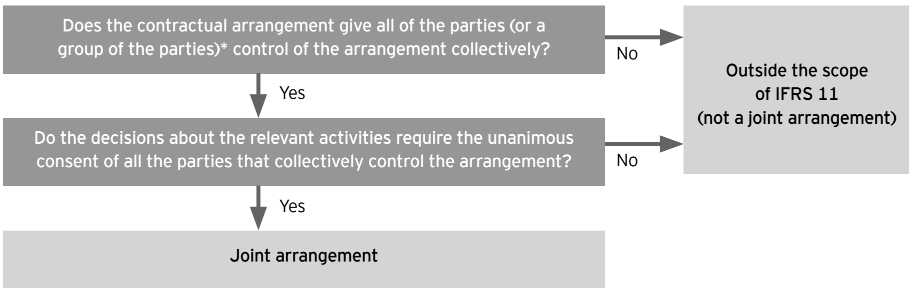
The key elements of joint control are as follows:

- *Contractually agreed* — contractual arrangements are usually, but not always, written, and set out the terms of the arrangements
- *Control and relevant activities* — IFRS 10 describes how to assess whether a party has control, and how to identify the relevant activities
- *Unanimous consent* — exists when the parties to an arrangement have collective control over the arrangement, but no single party has control

The following flowchart provides a process for determining if a joint arrangement exits.

An entity will need to apply judgement when assessing whether all the parties, or a group of the parties, have joint control of an arrangement, by considering all facts and circumstances. Understanding the purpose and design of an arrangement is crucial to identifying whether there is joint control. If it is determined that the parties do not have joint control (or control), the parties either recognise: (a) their interests in specific assets and liabilities; or (b) their rights to the net assets under IAS 32/ IAS 39/IFRS 9 or by applying equity accounting if the parties have significant influence.

Diagram 1 — Is it a joint arrangement?

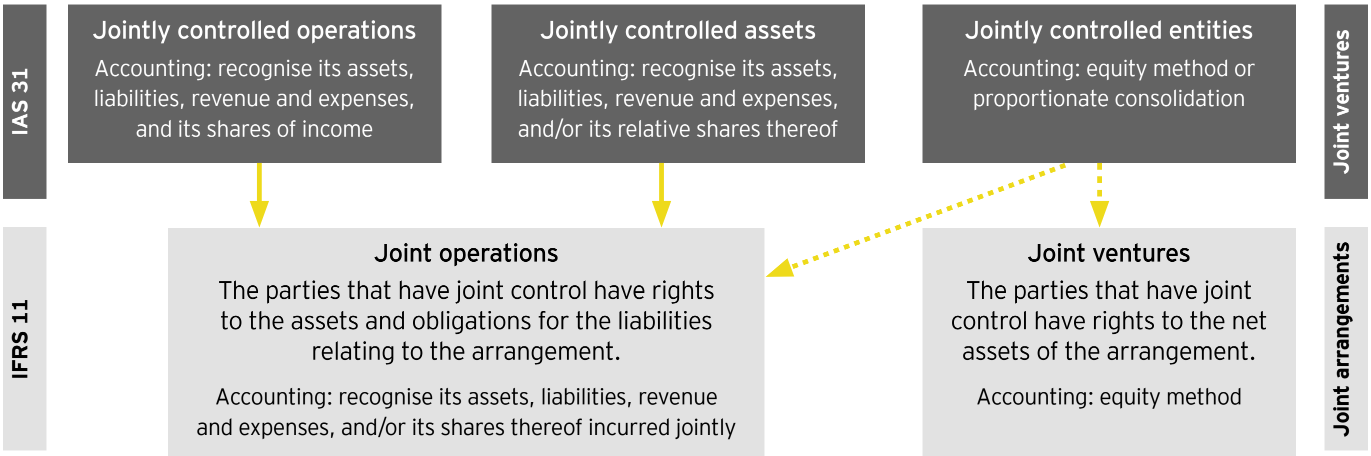


* The reference to "a group of the parties" applies to a situation in which there is joint control between two or more parties, but other parties to the joint arrangement are passive investors (i.e., there are other parties in the arrangement who do not have joint control). While such investors are technically within the scope of IFRS 11, they account for their investment in accordance with the relevant standard (e.g., IAS 28 if they have significant influence, or as a financial instrument).

4. Changes to accounting for joint arrangements

Once it has been established there is joint control, arrangements are then classified as either joint operations or joint ventures, which is different from the classification, and accounting, required under IAS 31. The following diagram compares the accounting for joint ventures under IAS 31 to the accounting for joint arrangements under IFRS 11.

Diagram 2 — Similar concepts, different terms



As shown in the diagram, investments in jointly controlled operations and jointly controlled assets under IAS 31 will be considered investments in joint operations under IFRS 11, by virtue of the fact that they are not structured through a separate entity. The accounting for these arrangements under IFRS 11 will generally be the same as the accounting under IAS 31. However, investments in jointly controlled entities under IAS 31, will be considered either investments in joint operations or joint ventures under IFRS 11. This determination, which will be based on the rights and obligations of the parties to the arrangement, will likely cause the most significant changes under the new standard. IAS 31 allowed parties to elect either the equity method or proportionate consolidation method to account for their investments in jointly controlled entities. IFRS 11 removes this election and requires parties to account for investments in joint ventures under the equity method and to account for investments in joint operations based on their rights to, and obligations for, the underlying assets, liabilities, revenue and expenses.

The classification of joint arrangements depends upon the parties' rights and obligations arising from the arrangement in the normal course of business. When an entity has rights to the arrangement's assets and obligations for the arrangement's liabilities, the arrangement is a joint operation. When an entity has rights to the net assets of the arrangement, the arrangement is a joint venture.

4.1 Joint operations

Jointly controlled assets and jointly controlled operations (as defined under IAS 31) are called joint operations under IFRS 11. The way that information is presented for these arrangements will generally remain the same when an entity transitions to IFRS 11. That is, the joint operator (defined as a party that has joint control of a joint operation and not to be confused with the operator of the joint arrangement) continues to recognise its assets, liabilities, revenues and expenses, and/or its relative share of jointly held assets, jointly incurred liabilities and revenue/expenses, which were jointly produced/incurred, if any. As mentioned, people often incorrectly refer to this accounting as proportionate consolidation, when in fact it is not. A further description of proportionate consolidation is provided later in this publication.

Previously defined jointly controlled entities with rights to assets and obligations for liabilities could be classified as joint operations under IFRS 11 depending on the individual facts and circumstances of the joint arrangement. Even if the arrangement has a separate legal structure, when the party has rights to the assets and obligations for the liabilities of the underlying joint arrangement, it will be classified and accounted for as a joint operation.

It is important to note that not all current jointly controlled entities will automatically be considered joint ventures under IFRS 11 – detailed analysis will be required.

The accounting for joint operations follows the principle that IFRS 11 establishes: the accounting for joint arrangements should reflect the rights and obligations that the parties have as a result of their interests in the arrangements, regardless of those arrangements' structure or legal form. A joint operator shall recognise the following in relation to its interest in a joint operation:

- Its assets, including its share of any assets held jointly
- Its liabilities, including its share of any liabilities incurred jointly
- Its revenue from the sale of its share of the output arising from the joint operation
- Its share of the revenue from the sale of the output by the joint operation
- Its expenses, including its share of any expenses incurred jointly

How we see it

The accounting for joint operations under IFRS 11 will likely not change significantly from the accounting applied to jointly controlled operations or jointly controlled assets under IAS 31.

4.2 Joint ventures

Jointly controlled entities with rights to the joint arrangement's net assets will be classified and accounted for as a joint venture under IFRS 11. The joint venturer (now defined as a party who has joint control of a joint venture) will then be required to apply equity accounting to this investment. Investments that provide rights to the net assets of the joint arrangement can no longer apply proportionate consolidation under IFRS 11.

5. Classification of a joint arrangement

The classification of a joint arrangement between a joint operation and a joint venture will require thorough analysis of the facts and circumstances and may involve the application of significant judgement. The conclusion may have a significant impact on an entity's financial statements.

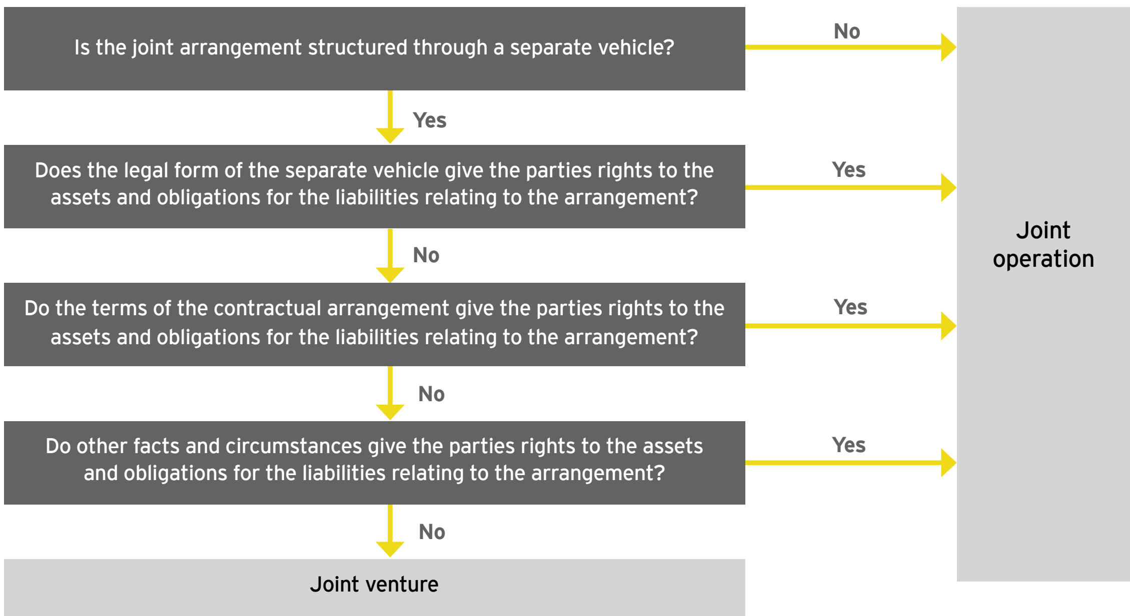
Power and utilities companies that currently account for jointly controlled entities under proportionate consolidation may desire to continue recognising the specific assets and obligations. These companies will need to identify the terms of current agreements and revise or structure future arrangements to have rights to specific assets and obligations for specific liabilities (and therefore qualify as a joint operation under IFRS 11) as opposed to the net assets of the arrangement (i.e., a joint venture under IFRS 11).

When classifying a joint arrangement as either a joint operation or a joint venture, the first step is to assess whether there is a separate vehicle. If not, the joint arrangement is automatically a joint operation. However, if there is a separate vehicle, the following factors will also need to be considered before concluding the arrangement is a joint venture:

- Legal form of the separate vehicle
- Contractual terms and conditions
- Other facts and circumstances

This process of classifying a joint arrangement is described in the flow chart below. This flow chart illustrates several criteria that must be met for the joint arrangement to be classified as a joint venture. If just one of the criteria indicates that the parties have the rights to the assets and obligations for the liabilities, the joint arrangement would be classified as a joint operation.

Diagram 3 — Classifying a joint arrangement



It should be noted that when classifying a joint arrangement, the IASB generally expects that all parties to that joint arrangement would reach the same conclusion regarding classification of that joint arrangement. To reach different conclusions regarding the classification of a joint arrangement would mean that the parties have different rights to assets and obligations for the liabilities within the same arrangement, which the IASB believes would be rare.

5.1 Separate vehicle
Despite stating that the legal form or structure of a joint arrangement is not the most significant factor in classifying the joint arrangement as a joint operation or a joint venture, the first factor in classifying a joint arrangement is the assessment of whether a separate vehicle exists. If yes, then further evaluation must be completed to classify the joint arrangement. However, if no separate vehicle exists, then the joint arrangement is always a joint operation.

5.2 Legal form of the separate vehicle
Once it is determined that a separate vehicle exists, the next step is to analyse the legal form of the separate vehicle. This is a significant change from IAS 31, where the accounting solely depends on whether a separate vehicle exists. Under IFRS 11, the legal form of the separate vehicle must be assessed to determine whether it gives the parties rights to net assets, or rights to the assets and liabilities for the obligations of the arrangement. In other words, does the legal form of the separate vehicle confer separation between the parties and the separate vehicle itself?

5.3 Consideration of contractual terms
When evaluating the classification of a joint arrangement, it is important to examine the contractual terms of the arrangement to determine whether they provide the parties with rights to the net assets (a joint venture) or rights to the assets and obligations for the liabilities (a joint operation). This is because, even if the legal form of the separate vehicle might establish rights for each of the parties, the contractual terms of the joint arrangement could unwind the effects of the legal form and give the parties rights to the assets and liabilities for the obligations. The requirement to focus on the nature and substance of the rights and obligations of the joint arrangement is a change from IAS 31, which solely looks to the form of the arrangement.

Example — How the contractual terms can change the parties' accounting for a joint arrangement
Electricity companies A and B (involved in electricity sales, but not distribution) jointly establish a power generation entity (company C) to build and operate a combined cycle gas turbine ("CCGT") power plant. Companies A and B each have a 50% ownership interest in company C, which is structured as a corporation. The incorporation enables the separation of company C from companies A and B and, as a consequence, the assets and liabilities held in the joint arrangement are the assets and liabilities of company C. In the absence of other facts and circumstances, the assessment of the rights and obligations conferred upon companies A and B by the legal form of the separate vehicle indicates that companies A and B have rights to the net assets of company C (i.e., a joint venture). Companies A and B would apply the equity method of accounting.

However, if a joint arrangement agreement governing the development and operations of the CCGT states that companies A and B have an interest in the assets of company C and an obligation for the liabilities of company C in a specified proportion, the contractual terms modify the effects of the legal form (corporation). Therefore, company C would be a joint operation and companies A and B would recognise their individual interests in company C's assets and liabilities.

The table below provides examples of common contractual terms found in joint arrangements and whether these terms are general indicators of joint operations or joint ventures.

	Joint operation	Joint venture
Rights to assets	The parties share all interests (e.g., rights, title or ownership) in the assets relating to the arrangement in a specified proportion.	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (e.g., no rights, title or ownership) in the assets of the arrangement.
Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion.	The joint arrangement is liable for the debts and obligations of the arrangement.
	The parties are jointly and severally liable for the obligations of the arrangement.	The parties are liable under the arrangement only to the extent of their respective investments in the arrangement, or to their respective obligations to contribute any unpaid or additional capital to the arrangement, or both.
	The parties are liable for claims raised by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party with respect to debts or obligations of the arrangement.

5.4 Other facts and circumstances to consider

If the preliminary assessment of the legal form and the contractual terms indicate that a joint arrangement may be a joint venture, then the parties must consider any other facts and circumstances to determine whether they each have rights to the assets and obligations for the liabilities, which would make it a joint operation.

When considering other facts and circumstances associated with a joint arrangement that is structured through a separate vehicle, an entity evaluates two critical questions about the joint arrangement — have the parties designed the arrangement so that:

- Its activities primarily aim to provide the parties with an output (i.e., the parties have rights to substantially all of the economic benefits of the assets held in the separate vehicle)

And

- It depends on the parties on a continuous basis to settle its liabilities relating to the activity conducted through the arrangement

If both of the above criteria exist, then the arrangement is a joint operation. In some cases, judgement will be needed to assess whether these criteria are met. The table below provides examples of the application of these criteria and the likely classification of the arrangement.

	Joint operation	Joint venture
Restrictions on selling output	Restricted from selling output to third parties	No restrictions; may sell output to third parties
Requirements to purchase output	Parties (individually or collectively) must purchase substantially all output produced	No requirements; third parties may purchase output
Source of cash flows to pay liabilities	The parties provide cash flows through their purchases of output	Cash flows received from third parties through their purchases of output
Expected financial performance	Designed to operate at break-even or to generate losses that will be funded by the parties	Designed to generate a profit

Example — Illustrating how the facts and circumstances might indicate that the joint arrangement is a joint operation, even if the legal form and contractual terms point towards the joint arrangement being a joint venture

This example has been adapted from Example 5 in the Basis for Conclusions on IFRS 11, paragraph BC32.

Electricity companies A and B (involved in electricity sales but not distribution) jointly establish a power generation entity (company C) to build and operate a CCGT power plant. Companies A and B each have a 50% ownership interest in company C, which is structured as a corporation. The incorporation enables the separation of company C from companies A and B and, as a consequence, the assets and liabilities held in company C are the assets and liabilities of company C. The contractual arrangement between the parties does not specify that the parties have rights to the assets or obligations for the liabilities of company C.

However, the parties also enter into an off-take agreement requiring the following:

- Companies A and B agree to purchase all the power generated by company C in a ratio of 50:50. Company C cannot sell any of the output to third parties, unless this is approved by companies A and B. Because the purpose of the arrangement is to provide companies A and B with power they require, such sales to third parties are expected to be uncommon and not material.
- The price of the power sold to companies A and B is set forth in the off-take agreement at a level that is designed to cover the costs of production and administrative expenses incurred by company C. The arrangement is intended to operate at a break-even level.

Analysis under IFRS 11

The obligation of companies A and B to purchase all of the electricity produced by company C reflects the exclusive dependence of company C upon companies A and B for the generation of cash flows. In addition, because companies A and B have rights to all of the electricity produced by company C, they are consuming, and therefore have rights to, all of the economic benefits of the assets of company C. In the absence of other facts and circumstances, this would indicate that the arrangement is a joint operation.

The conclusion on the classification of the joint arrangement is not impacted by the fact that, as electricity sales companies (or utilities), companies A and B sell their share of the electricity generated by company C to retail customers.

However, if companies A and B changed the terms of the off-take agreement so that the company C is able to sell a significant portion of its generated electricity to third parties, company C would be assuming demand, production and credit risks. As such, companies A and B would not have obligations for substantially all of the liabilities or rights to substantially all of the economic benefits of the assets of company C. Accordingly, the joint arrangement would likely be classified as a joint venture.

5.5 Cash contributed at the inception of an arrangement

IFRS 11 indicates that if a joint arrangement depends on the parties for settling its liabilities on a continuous basis, it would be indicative of a joint operation.

Excerpt from IFRS 11

B32 The effect of an arrangement [designed for the provision of output to the parties] is that the liabilities incurred by the arrangement are, in substance, satisfied by the cash flows received from the parties through their purchases of the output. When the parties are substantially the only source of cash flows contributing to the continuity of the operations of the arrangement, this indicates that the parties have an obligation for the liabilities relating to the arrangement.

Questions have arisen whether parties would be considered "substantially the only source of cash flows" if they provide cash flows at inception of a joint arrangement, but are not expected to thereafter. Alternatively, parties might provide cash flows through a series of cash calls throughout the arrangement.

How we see it

In our view, when parties provide cash flows at inception of a joint arrangement, but do not expect to provide cash thereafter, the fact that they are the only source of cash flows in the interim does not mean that the joint arrangement is a joint operation. This is because they are not providing cash on a continuous basis, and are not expected to have an obligation to fund the liabilities of the joint arrangement in the normal course of business. Similarly, a requirement or expectation of providing cash flows through a series of cash calls does not necessarily mean that the joint arrangement is a joint operation.

5.6 Guarantees

Parties to joint arrangements may provide guarantees to third parties (e.g., lenders or regulators). For example, a party to a joint arrangement might provide a guarantee or commitment that:

- Services provided by the joint arrangement to the third party will be of a certain quality or nature
- The joint arrangement will repay funding received from the third party
- It will support the joint arrangement in the event of distress

One might think that providing a guarantee (or commitment to provide a guarantee) gives a party an obligation for a liability, which would indicate that the joint arrangement should be classified as a joint operation. However, IFRS 11 states this is not the case.

How we see it

Although perhaps counter-intuitive, the fact that a guarantee is not determinative of the classification of a joint operation is consistent with the principles in IFRS 11. This is because the guarantee does not give the guarantor a present obligation for the underlying liabilities.

If the issuer of the guarantee has to pay or perform under that guarantee, this might indicate that facts and circumstances have changed, or the issuance of a guarantee might be accompanied by a change in the contractual terms of the arrangement. This change would trigger a reassessment of whether the arrangement is still subject to joint control, and if so, whether the joint arrangement is a joint operation or a joint venture.

The party issuing the guarantee must still account for the guarantee in accordance with IAS 39. However, the mere existence of the guarantee does not affect the classification of the joint arrangement.

Example — Impact of a guarantee on the classification of a joint arrangement

This example has been adapted from Illustrative Examples for IFRS 11 paragraphs IE44-52.

Company A owns a land and a permit to build a combined cycle power plant in a region where available power production capacities are low. Based on a financial analysis, company A determines that the power plant will generate significant returns if power is sold on the wholesale market, and not through a long-term Power Purchase Agreement (PPA). Considering the size of the investment and the volatility of commodity prices, company A decides to bring in a partner to share the burden of this investment and the associated risks.

Company A enters into a joint arrangement with Company B to build the combined cycle power plant. Under that arrangement, companies A and B (the parties) agree to contribute the land (including the related permit) and cash, respectively, to a new separate vehicle, entity C. In exchange for those contributions, the parties each take a 50% 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:

(a) 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.

(b) Day-to-day management of the power plant, including 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 B for the costs it incurs in managing the power plant.

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

(d) 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.

Further details of the arrangement include:

- 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 lender to help fund the construction of the power plant. The estimated total cost of the development and construction is CU1,000 million.
- The lender provides entity C with a CU700 million loan. The arrangement specifies that the lender has recourse to companies A and B only if entity C defaults on the loan arrangement during the construction of the power plant. The lender agrees that it will not have recourse to companies A and B once the power plant is in operation because it has assessed that the cash inflows that entity C should generate from sale of electricity 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 power plant.

Analysis under IFRS 11

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 appear to establish that the parties have rights to the net assets of entity C. The recourse nature of the financing arrangement during the construction of the power plant (i.e., companies A and B provided 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 remains a liability of entity C). Companies A and B would have separate liabilities, which are their guarantees to repay that loan if entity C defaults during the construction phase.

There are no other facts and circumstances in this example 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. Accordingly, the parties would recognise their rights to the net assets of entity C as investments and account for them using the equity method.

5.7 Clarifying the accounting … what is proportionate consolidation?

As mentioned earlier, there is some misunderstanding as to what proportionate consolidation is under IFRS. Specifically, how it is applied to jointly controlled assets and jointly controlled operations under IAS 31 and how it compares with the accounting applied to joint operations under IFRS 11. This confusion is partly due to the two approaches being technically different, from an accounting perspective, and also partly due to the way US GAAP uses the term 'proportionate consolidation'. Under US GAAP, proportionate consolidation is used to describe a method of accounting that would be the equivalent of IFRS's JCA/JCO (and now joint operations) accounting.

As a consequence, there is some unwarranted concern that all interests in joint arrangements will require equity accounting – which is not the case. Additionally, for entities that elected to apply proportionate consolidation to jointly controlled entities under IAS 31, and that will classify the arrangements as joint operations under IFRS 11, the adoption of IFRS 11 may not have a significant impact on their financial statements.

The following illustrates the impact of transitioning from proportionate consolidation to accounting for joint operations under IFRS 11:

- When a joint operator has rights to a specified percentage of all assets (e.g., 50%) and obligations for the same specified percentage (50%) of all liabilities, there would likely be no difference between the accounting for a joint operation and proportionate consolidation.
- However, when a joint operator has rights to a specified percentage of certain assets and differing rights (and percentages) to other assets, the financial statements would look different when accounting for those individual rights and obligations, as compared to proportionate consolidation. This is also true when an entity has obligations for a specified percentage of certain liabilities and differing obligations (and percentages) for other liabilities. The following table shows how these differences would be presented in an entity's financial statements. In this scenario, Party A and Party B are involved in a 50% / 50% joint arrangement. Party A has rights to 100% of the joint arrangement's truck and Party B has an obligation for 100% of the joint arrangement's debt.

		Proportionate consolidation		IFRS 11 – Joint operations accounting	
Item	**100% amount**	**Party A 50%**	**Party B 50%**	**Party A**	**Party B**
Truck*	200	100	100	200	–
Other assets	1,000	500	500	500	500
Debt**	(100)	(50)	(50)	–	(100)
Other liabilities	(80)	(40)	(40)	(40)	(40)

* Party A has rights to 100% of the truck.

** Party B has obligations for 100% of the debt.

The removal of proportionate consolidation will not affect the accounting currently applied to jointly controlled operations or jointly controlled assets under IAS 31.

6. Impact of a change in classification upon transition

6.1 Jointly controlled entity (proportionate consolidation) to joint venture

When proportionate consolidation was previously used for jointly controlled entities under IAS 31, and such arrangements are classified as joint ventures under IFRS 11, the transition to equity accounting will result in substantial changes to the financial statements of the joint venturer.

6.2 Jointly controlled entity (proportionate consolidation) to joint operation

For some arrangements, the transition from a jointly controlled entity, in which the company elected to apply proportionate consolidation, to a joint operation will have no impact on its financial statements. However, in situations where an entity does not have a uniform percentage interest in all assets and liabilities, it is likely that the accounting for proportionately consolidated jointly controlled entities, which will be classified as joint operations under IFRS 11, will result in changes to the financial statements.

6.3 Presentation impacts

These changes will impact the presentation of the financial statements of affected entities. For example, going from proportionate consolidation to equity accounting will cause the investment in the joint arrangement to go from being presented on multiple line items throughout the statements of financial position and performance, to single equity-accounted line items.

There could also be impacts on key IFRS metrics. As an example, entities that calculate EBITDA using the amounts reported under IAS 31 on the face of the financial statements (without adjustment) would exclude the joint arrangement party's share of any interest, income tax, depreciation or amortisation on the joint arrangement if the proportionate consolidation method was used. Unless the entity chooses to adjust its calculation of EBITDA, these amounts would be included in the single line item of investment income or expense under IFRS 11 and, as such, would also be included in the measure of EBITDA. However, as EBITDA is not a measure that is defined in IFRS, there is no standardised calculation. Entities in certain regulatory areas may simply choose to revise their EBITDA calculation or other non-IFRS measures.

6.4 Measurement impacts

In some cases, there may also be measurement differences that will affect profit or loss and/or net assets. For example, under proportionate consolidation, any losses from a joint arrangement would have been recognised as incurred. However under equity accounting, losses would only continue to be recognised up until the point at which the investment in the joint arrangement is reduced to nil.

For more information on the practical implications of these changes for your business (e.g., accounting systems and processes, management information and key performance indicators) refer to the *IFRS Practical Matters* publication referenced in *Additional materials* at the beginning of this publication.

How we see it

When investments in jointly controlled entities that were proportionately consolidated are material, and such arrangements will be classified as joint ventures under IFRS 11, there will be a significant impact on the presentation of the financial statements of affected entities. In some cases, there may also be measurement differences, which will affect profit or loss and/or net assets. Significant changes will also occur when an equity accounted jointly controlled entity is considered to be a joint operation under IFRS 11. In this situation, the joint operator will recognise its assets, liabilities, revenues and expenses, and/or its relative share of jointly held assets, jointly incurred liabilities and revenue/expenses that were jointly produced/incurred, if any.

Because of the changes to classifying a joint arrangement introduced by IFRS 11, we caution entities against voluntarily changing from proportionate consolidation to the equity method while still under IAS 31, until they have fully assessed how their jointly controlled entities are classified under the new standard.

When an operator of a joint arrangement has a direct legal liability for the entire balance of certain obligations arising from transactions of the joint arrangement, it should recognise the full amount of these liabilities and separately recognise a receivable from the non-operator parties. These amounts cannot be offset.

7. Operators of joint arrangements – what should be recognised?

IFRS 11 requires a participant in a joint operation to recognise its assets, liabilities, revenues and expenses and/or its share of the assets, liabilities, revenues and expenses incurred jointly. Additional consideration is required if one of the participants to the arrangement is also an operator of the joint arrangement. Therefore, it is important an entity fully understands its rights and obligations arising from the joint arrangement.

7.1 Operators

Operators of joint arrangements may have a direct legal liability for the entire balance of certain obligations arising from transactions of the joint arrangement. These may include, but are not limited to, third party creditors, leases, and employee liabilities. They may also have a right of reimbursement (by virtue of the joint operating agreement) from the non-operator parties. In this case, the operator would be required to recognise 100% of such liabilities and would recognise a receivable from the non-operator parties for their share of such liabilities. IFRS prohibits the offsetting of these liabilities against these receivables.

While, in most circumstances, the ability of the non-operator parties to pay their share of the costs incurred by the operator will not be in doubt, particularly when cash calls are paid in advance, there may be instances when they are unable to pay. Here the operator might not be able to recognise a corresponding receivable, and consequently, this would negatively impact its financial statements.

7.2 Non-operator parties

Continuing with the situation described in 7.1 above, non-operators would recognise a payable to the operator, which would be accounted for as a financial instrument under IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments* and not under the standard that relates to the types of expenses being reimbursed. This would mean different measurement and/or disclosure requirements would apply. For example the non-operator's share of employee entitlements of the operator's employees who work on the joint project, would not be accounted for under IAS 19 *Employee Benefits*.

7.3 Joint and several liability

It is also possible that there may be liabilities in the arrangement when the obligation is joint and several. That is, an entity is not only responsible for its proportionate share, it is also liable for the other parties' share should they be unable to pay.

In these instances, each party not only takes up its proportionate share of the obligation, it is also required to assess the likelihood that the other party/ies will be unable to meet their share of the obligation. When the likelihood is remote that they will not be able to pay, the entity is not required to record any additional obligations. When there is some indication the other party/parties may not be able to pay, but it is not probable that they are unable to pay, then the entity would have to disclose this possible obligation as a contingent liability. However, when it is probable that they cannot meet some, or all, of the obligation, the entity would need to assess the additional amount it would have to recognise.

How we see it

It will be critical for parties to joint arrangements to undertake a detailed review of their joint operating agreements, including any subsequent amendments or addendums, to ensure they fully understand the rights and obligations therein, and how these are shared amongst the parties.

In many instances, the requirement for the operator to recognise 100% of certain liabilities, and a separate receivable from the non-operator parties, will not negatively impact the operator's (or entity's) financial statements. However, recent events illustrate that non-operator/other parties may not always be able to meet their share of obligations of the joint arrangement.

8. So what if I don't have joint control or control?

The accounting impact of concluding that an interest in an arrangement does not provide the party with joint control or control depends on a number of factors. The most important of these will be the rights and obligations the contractual arrangement provides the party or parties.

8.1 Identifying and assessing the rights and obligations

- Rights to the underlying assets and obligations for the underlying liabilities of the arrangement — despite not having joint control (or control) the party still has rights to, and obligations for, the underlying assets and obligations. Therefore, it would continue to recognise its interest in those assets and liabilities. This accounting would apply regardless of whether the arrangement is in a separate vehicle or not, as the contractual terms are the primary determinant of the accounting.
- Rights to the net assets — this only occurs when, at a minimum, the arrangement is structured through a separate vehicle. In this instance, the party to the arrangement accounts for its interest under IAS 32/IAS 39/IFRS 9, unless it has significant influence over the arrangement. In this case it accounts for its interest in accordance with IAS 28 *Investments in Associates and Joint Ventures* (as amended in 2011), which would mean applying equity accounting.

8.2 Does the arrangement represent a business?

One area where there is currently a lack of clarity when accounting for acquisitions of interests in jointly controlled assets and jointly controlled operations, and unless resolved, will present similar issues for joint operations, is whether the principles of IFRS 3 *Business Combinations* apply.

- One view is that IFRS 3 does not apply. This is on the basis that even though the activity of the JCA/JCO or joint operation may constitute a business, the venturer/joint operator does not control that business — it only has joint control.
- The other view is that IFRS 3 is applicable. This is on the basis that the unit of account for assessing control is the venturer's/joint operator's own interest in the business of the JCA/JCO or joint operation, and the entity controls this.

This lack of clarity has lead to diversity in practice. This issue was recently referred to the IFRS Interpretations Committee (the Committee) — and considered at their July 2011 meeting (agenda paper 9). The Committee continued its discussion at the September 2011 meeting, but did not arrive at a conclusion. The Committee directed the staff to perform further analysis on whether a premium paid for synergies can be recognised as a separate asset under another standard (e.g., IAS 38 *Intangible Assets*) in circumstances when an entity acquires an interest in a joint operation that contains a business, or whether IFRS 3 could be applied by analogy, and whether further guidance should be developed on this issue. As such, at the date of this publication, this issue is still being considered by the Committee.

How we see it

When a contract provides an entity with rights to the assets and obligations for the liabilities of the arrangement, concluding that the entity does not have joint control (or control) over such an arrangement would not change the accounting that would be achieved if the entity had joint control. However, different disclosure requirements apply.

For arrangements in which the entity has rights to the net assets, the accounting will be the same if it is considered to have significant influence, as it will continue to apply equity accounting. However, if the entity does not have significant influence, it will be required to measure the investment at fair value, which will have significantly different impacts on the financial statements, both from a measurement and disclosure perspective.

Given that the accounting for these contractual arrangements depends on the rights and obligations provided to the parties, it is essential for an entity to obtain a thorough understanding, and complete a detailed analysis, of its rights and obligations.

9. New disclosures … more information; impact on processes and systems

IFRS 12 introduces a range of new and expanded disclosures. These will require the disclosure of significant judgements and assumptions made by management in determining whether there is joint control and whether an arrangement structured through a separate vehicle is a joint venture or a joint operation. For joint ventures, it will also require the compilation and disclosure of additional information, either individually for material joint ventures, or in aggregate for any immaterial joint ventures. Further discussion is provided in our document *Applying IFRS — Challenges in adopting and applying IFRS 11* (September 2011).

For more information on the practical implications of these changes on your business (e.g., on accounting systems and processes, data accumulation), refer to *IFRS Practical Matters* referenced in *Additional materials* at the beginning of this publication.

10. Differences between IFRS and US GAAP

The issuance of IFRS 11 is a significant step in converging with US GAAP, and was a part of the 2006 Memorandum of Understanding between the IASB and the FASB. US GAAP generally does not allow proportionate consolidation, which was permitted under IAS 31. Upon the issuance of IFRS 11, both IFRS and US GAAP generally require application of the equity method to account for joint ventures.

The main differences that will continue to exist between IFRS 11 and US GAAP are summarised below:

- There are differences in the definitions of joint arrangements and joint control. Joint arrangements are limited to 'corporate joint ventures' under US GAAP. The IFRS definition is broader and encompasses non-entity arrangements and arrangements structured through any type of entity (incorporated or unincorporated). In addition, the definition of 'joint control' provided in US GAAP is potentially wider than the definition in IFRS because the nature of the decisions that might need the agreement of 'two or more owners' is not defined as necessarily being the decisions on the 'relevant activities'. Furthermore, arrangements in which the parties might collectively control the arrangement could potentially fulfil the definition of 'joint control' under US GAAP because 'unanimous consent' is not required.
- For arrangements that are structured through a separate vehicle and the parties have rights to the assets and obligations of the liabilities of the arrangements, US GAAP will require equity accounting and IFRS will require accounting for the separate assets and liabilities.

11. Conclusion

Joint arrangements are, and are likely to continue to be, a common method for managing risks in the power and utilities sector. As a result, IFRS 11 is expected to have a widespread impact on a large number of entities in this sector. This means that entities need to take steps now to address the concerns. Although this publication is one of the first steps towards better understanding the nature of these changes, much more effort will be required to successfully implement these changes.

Entities need to review their existing arrangements to identify those arrangements that are within the scope of IFRS 11 and then assess how the accounting may be impacted. As emphasised throughout this publication, assessment will involve the application of significant judgement. Further, the rights and obligations provided to a party under these contractual arrangements will ultimately drive the accounting. Therefore, an entity will have to ensure it has a detailed understanding of the specific rights and obligations of its arrangements to be able to determine the impact of these new standards.

Given the unique nature of the various arrangements that currently exist, and are emerging, an entity will need to individually analyse each contract to be able to complete this assessment. The difficulty of this task will be impacted by the number and complexity of the arrangements an entity has. Robust systems and processes will need to be developed, not only to complete the initial assessment, but also to enable the ongoing assessment of current arrangements (should facts and circumstances change) and the assessment of new arrangements.

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