# Practical guide to IFRS

## Classification of joint arrangements

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### What is the issue?

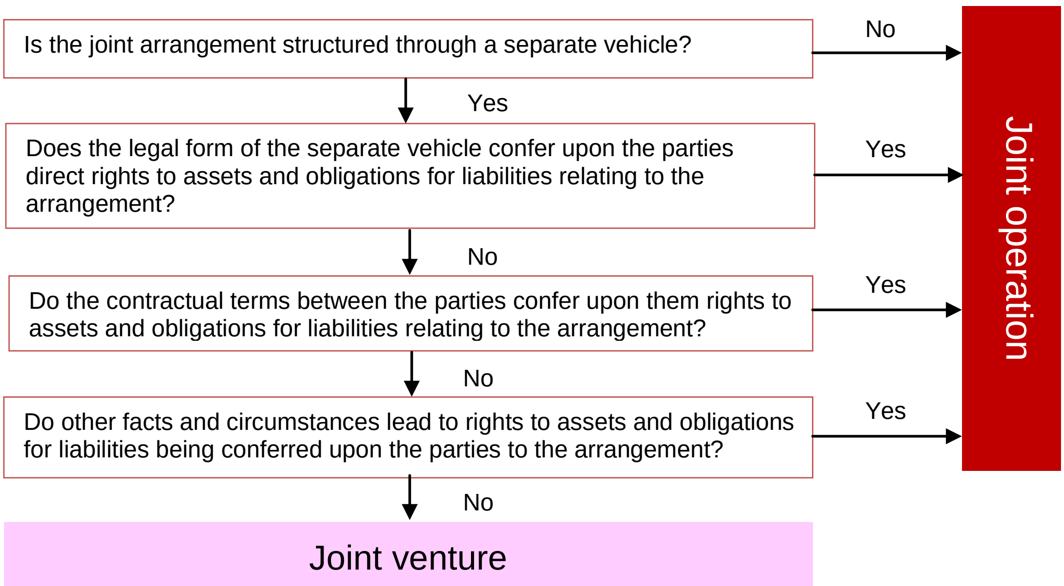
The classification of joint activities under IAS 31 seldom created any controversy or even much in the way of discussion. Unincorporated activities were either jointly controlled operations or jointly controlled assets with identical accounting. Anything in a legal entity was 'jointly controlled entity', with management able to choose between proportionate consolidation or equity accounting. Hence, there was seldom any pressure on the classification of a joint arrangement. IFRS 11 has changed all that; the policy choice has been abolished and accounting and presentation is determined by the classification of the joint arrangement. The decision on classification will be straight-forward in most cases, but there will be instances where significant analysis and the exercise of judgement is required.

Classification under IFRS 11 is driven by the rights and obligation of the parties arising from the arrangement rather than the legal form of the arrangement. There are now only two types of joint arrangement and two types of accounting; joint venture (equity accounting) and joint operation (direct accounting for assets and liabilities).

Arrangements that were classified as jointly controlled operations and joint controlled assets under IAS 31 will be classified as joint operations under IFRS 11, as explained below. The potential change in classification will arise in respect of joint arrangements conducted in legal entities. A joint arrangement undertaken in a legal entity that creates separation between the parties to the arrangement and the arrangement is most likely to be classified as a joint venture under IFRS 11, but this will not always be the case. There will be some joint arrangements in legal entities that will be classified as joint operations because of the contractual arrangements between the parties or other relevant facts and circumstances.

### A four-step process

Determining the classification of joint arrangements can be set out as a four-step process, as shown below.



### *Step 1 – Is the joint arrangement structured through a separate vehicle?*

A separate vehicle is a separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality.

The most common forms of vehicle used to structure joint arrangements are limited liability companies, partnerships, corporations, associations and trusts. Each of these is a separately identifiable financial structure, having separately identifiable assets, liabilities, revenues, expenses, financial arrangements and financial records, and would be a separate vehicle.

The definition of a 'separate vehicle' in the standard is, however, quite broad. The separate vehicle does not necessarily need to have a legal personality. A contractual arrangement between two parties may also create a separate vehicle, although this is expected to occur infrequently.

Local laws and regulations should be considered before determining whether a particular structure meets the definition of a 'separate vehicle'.

#### *Joint arrangements not structured through a separate vehicle*

An arrangement that is not structured through a separate vehicle is a joint operation. The parties in the joint arrangement determine the rights to the assets and obligations for the liabilities among the parties. Much upstream activity in the oil and gas industry, for example, takes place in undivided interest working arrangements where the parties share joint control, fund development and operations, and take away their share of the production.

#### *Joint arrangements structured through a separate vehicle*

A joint arrangement that is structured through a separate vehicle is either a joint venture or a joint operation depending on the parties' rights and obligations relating to the arrangement.

The parties need to assess whether the legal form of the separate vehicle, the terms of the contractual arrangement and, when relevant, any other facts and circumstances give them:

(a) rights to the assets and obligations for the liabilities relating to the arrangement (that is, joint operation); or

(b) rights to net assets of the arrangement (that is, joint venture).

### *Step 2 – Does the legal form of the separate vehicle confer upon the parties direct rights to assets and obligations for liabilities relating to the arrangement?*

The second step in determining the classification is to assess the rights and obligations arising from the legal form of the separate vehicle.

Joint arrangements are established through many different legal structures, including limited liability companies, unlimited liability companies, limited liability partnerships, general partnerships and unincorporated entities. Each of these legal structures exposes the parties to a different set of rights and obligations.

If the legal structure is such that the parties have rights to assets and are obligated for the liabilities, it is a joint operation because the legal entity does not create separation between the parties and the arrangement. The relevant laws and regulations need to be carefully assessed. Many partnerships, for example, are designed to allow the partners direct access to the assets, impose unlimited liability for obligations and allow for flow through of tax attributes. This type of separate vehicle does not create separation between the participants and the arrangement.

The key question is – can the separate vehicle or legal entity be considered in its own right – that is, are the assets and liabilities held in the separate vehicle those of the separate vehicle, or are they the assets and liabilities of the parties?

**Examples of separate vehicles**

Partnerships, in many cases, do not create separation, as the partners are exposed to the liabilities and have rights to the assets of the partnership in the normal course of business. Some types of limited liability partnership (LLP) may create separation where the partners are not obligated for the liabilities of the LLP and the assets of the LLP are its own assets. The relevant law in the country where the LLP is domiciled should be considered, as the rights and obligations of the general partners and the limited partners may differ substantially in different circumstances.

Limited liability companies in most jurisdictions will create separation between the parties to the joint arrangement and the assets and liabilities of the arrangement. The creditors of the arrangement do not have a right to claim against the parties for unpaid debts. Unlimited liability companies exist in some jurisdictions and may still allow the parties direct rights to assets and obligations for liabilities.

Associations, trusts or specific types of corporation are other forms of legal entity used to establish joint arrangements. The rights and obligations arising from these structures vary significantly depending on jurisdictional laws and regulations. These should be assessed based on the specific facts and circumstances.

A separate vehicle that does not allow the parties rights to assets and obligations for liabilities relating to the arrangement indicates that the arrangement is a joint venture. However, the contractual terms between the parties and, when relevant, other facts and circumstances can override the legal form.

### *Step 3 – Do the contractual terms between the parties confer upon them rights to assets and obligations for liabilities relating to the arrangement?*

The rights and obligations agreed to by the parties in their contractual terms are normally consistent with the rights and obligations conferred on the parties by the legal form of the separate vehicle. The selection of a particular legal form is usually driven by the intended economic substance that the particular legal form delivers.

However, the parties to a joint arrangement may choose a particular legal form to respond to tax or regulatory requirements, or for other reasons. This may not be consistent with the economic substance sought by the parties to the arrangement. The parties might then enter into contractual arrangements that modify the legal form of the arrangement and create different rights and obligations. If the contractual terms give the parties rights to assets and obligations for liabilities, the arrangement is a joint operation.

The assessment of rights and obligations should be carried out as they exist in the 'normal course of business' (IFRS 11 B14). Legal rights and obligations arising in circumstances that are other than in the 'normal course of business', such as liquidation and bankruptcy, are much less relevant.

The creditors generally have the first right to the assets of a company in liquidation or bankruptcy. The shareholders only have rights in the net assets remaining after settlement of the third-party liabilities. This would suggest that a limited liability company could never be a joint operation, as the shareholders have rights only to the residual assets. However, IFRS 11 was not intended to create an 'in substance' policy choice for equity accounting simply through the insertion of a legal entity. IFRS 11 requires the economic substance of the joint arrangement to be considered through assessment of any contractual arrangements and other relevant facts and circumstances.

## Indicators in contractual arrangements – Joint operations

*Rights to assets*

The parties share all interests (for example, rights, title or ownership) in the assets in a specified proportion – either in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement.

*Obligations for liabilities*

The parties share all liabilities, obligations, costs and expenses in a specified proportion as in the case of rights to assets.

*Revenues and expenses*

The contractual arrangement usually establishes the allocation of revenues and expenses on the basis of the relative contribution or consumption of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly, which could differ from their ownership interest in the joint arrangement.

## Indicators in contractual arrangements – Joint ventures

*Rights to assets*

The assets and rights owned by the arrangement are those of the arrangement; the parties do not have any direct interests in the title or ownership of these assets.

*Obligations for liabilities*

The contractual terms establish that the arrangement is liable for the debts and obligations of the arrangement and that the parties are only liable to the extent of unpaid capital. Further, the creditors of the joint arrangement do not have rights of recourse against the parties.

*Revenues and expenses*

The parties share in the net cash flows and net profits of the arrangement in proportion to their shareholding.

*How are guarantees issued by the parties considered in determining the classification of a joint arrangement?*

Parties to joint arrangements may provide guarantees to third parties on behalf of the arrangement. This may be necessary in order to obtain financing or during the construction or development stages of a project. Does the provision of such guarantees (or commitment by the parties to pay in case the arrangement fails to pay or meet its obligations) indicate that the parties have direct obligations for the liabilities of the arrangement?

Rights and obligations are assessed, as they exist in the normal course of business. It is not appropriate to assume that the arrangement will not settle its obligations and that a guarantee will be called, as this would not be in the 'normal course of business'.

The provision of guarantees or commitments for funding are therefore not conclusive in determining classification, although these may be indicative of the willingness of the parties to the arrangement to fund the obligations of the arrangement and the dependence of the arrangement on the parties for cash flows.

### *Step 4 – Do 'other facts and circumstances' lead to rights to assets and obligations for liabilities being conferred upon the parties to the arrangement?*

Assessing 'other facts and circumstances' includes consideration of the purpose and design of the arrangement, its relationship to the parties and its source of cash flows. An arrangement designed primarily for the provision of output to the parties may indicate that the objective of the parties was to have direct access to the assets of the arrangement. The parties may be obligated to purchase or take all of the output of the joint arrangement. The purchase and sale agreements, off-take arrangements or cash calls may indicate that the parties are the sole source of cash flows for the joint arrangement.

The effect of an arrangement with such a design is that the liabilities incurred by the arrangement are in substance satisfied by the cash flows received from the parties and the parties are the only source of cash flows for the continuity of the arrangement's operations. This is indicative of a joint operation.

## Considerations when assessing 'other facts and circumstances'

Some or all of the following characteristics might indicate that a joint arrangement in a legal entity should be classified as a joint operation:

1. The joint arrangement may be prohibited from selling any of its output to third parties.
2. The parties have uninterrupted access to the output.
3. There is likely to be a binding obligation on the parties to purchase substantially all of the output.
4. The demand, inventory and credit risks relating to the activities of the arrangement are passed on to the parties and do not rest with the arrangement.
5. The output or services are priced to cover the costs of the arrangement and not expected to generate significant net income.
6. The arrangement is unlikely to have any third party borrowings without guarantees or take-or-pay arrangements with the parties.

*Application of classification criteria*

The following assumptions are common to each of the scenarios considered below:

(a) joint control exists; and

(b) there is a legal entity that creates separation between the parties and the joint arrangement.

The initial indicators are that the arrangements are joint ventures. The table below outlines how 'other facts and circumstances' might affect the classification of the arrangement.

| **Scenarios** | **Classification** | **Analysis** |
|---|---|---|
| The arrangement manufactures seats for automobiles. Both parties are in the business of assembly and sale of automobiles. Both are obligated to take output in proportion to their shareholding.<br><br>The price of the seats is set by the parties at a level such that the arrangement operates at break-even.<br><br>The arrangement is prohibited from selling the seats to third parties. | Joint operation | The design of the arrangement is to provide all its output to the parties. It is dependent on the parties for its cash flows to ensure continuity of operations. The parties get substantially all the economic benefits from the assets of the arrangement. |
| The joint arrangement produces a commodity such as oil which is readily saleable in the market. The parties are obligated to buy their share of the output. | Likely to be a joint operation | The parties are obliged to take their share of the output and in turn fund the operations of the joint activity. The fact that the product is readily saleable becomes less relevant because there is an obligation on the arrangement to sell all of its output to the parties. |
| The arrangement produces dry gas and gasoline.<br><br>100% of the dry gas is taken by one party and 100% of the gasoline is taken by the other party. The joint arrangement may not make sales to other parties. Both products are priced at raw material cost plus a processing margin to cover the operating costs of the joint arrangement.<br><br>Each party uses their respective product in their business. Any residual profit or loss in the arrangement is distributed by way of dividends to the parties in the proportion of their shareholding but is not significant. | Likely to be a joint operation | The parties may engage in the joint arrangement to obtain cost savings or to guarantee supplies. They do not have to share all the products in proportion to their shareholding.<br><br>The arrangement is dependent on the parties for cash flows and the parties take all the output. This is a strong indicator that the arrangement may be a joint operation. |
| Parties have a right of first refusal to buy the output from a joint arrangement but they are not obligated to take the output.<br>The arrangement was established three years ago.<br><br>Year 1: the parties take all the | Likely to be a joint venture | The following factors indicate that the arrangement is most likely a joint venture.<br><br>• There is no obligation on the arrangement to sell its output to the parties;<br>• Output has been sold to third |

| Scenarios | Classification | Analysis |
|---|---|---|
| output in the ratio of their shareholding. Year 2: the product is sold to third parties. Year 3: the parties take the output but in a ratio different from their shareholding. | | parties. This proves that the arrangement is not substantially dependent on the parties for its cash flows. |
| Two parties set up an arrangement to manufacture a product. The product is sold to third parties. Per the contractual terms: (a) all the gross cash proceeds from revenue of the arrangement are transferred to the parties on a monthly basis in proportion of their shareholding; (b) The parties agree to reimburse the arrangement for all its costs in proportion of their shareholding based on cash calls. | Likely to be a joint venture | The purpose and design of the arrangement is not to provide all of its output to the parties. The arrangement is selling the product to third parties and generating its own cash flows. Transferring gross proceeds of revenues to the parties and making cash calls for incurring its costs does not indicate that the parties have rights to assets and obligations for liabilities of the arrangement. It is merely a funding mechanism. It is no different from the parties having an interest in the net results of the arrangement. |
| Two parties set up a joint arrangement. One of the parties takes 100% of the output at market prices and the other party only takes its share of the profits/loss made by the entity. | Judgement required | All facts and circumstances have to be considered before determining the classification. Assessment of the economic rationale behind such arrangement might give an indication of the purpose and design of the arrangement. Assessment should be made whether one of the parties actually controls the arrangement or if there is an IFRIC 4 lease. If the arrangement is a joint arrangement, it seems to have some features of a joint operation and some of a joint venture. The arrangement does not sell to third parties and is dependent on one of the parties for its continuous cash flows, which indicates that it may be a joint operation. However, the other party does not consume any of the output and has an interest in the net profits of the arrangement. This indicates that it could be a joint venture. It is unlikely that one joint arrangement will include both a joint venture and a joint operation. Consideration should be given to all facts and circumstances before reaching a conclusion. |

The classification of joint arrangements under IFRS 11 depends upon the parties' rights and obligations arising from the arrangement as a whole and not just the rights and obligations inherent in the legal form of the arrangement. The legal form of the arrangement is just one of the factors considered in the assessment. The economic substance of the arrangement arising from the contractual terms agreed between the parties and other facts and circumstances plays a key role in determining the classification of a joint arrangement.

## *Other considerations*

Different joint arrangements or different types of joint arrangement can be established beneath the umbrella of a single framework agreement. One separate vehicle could conceivably include both a joint operation and a joint venture, although it would be rare in practice. This could occur when the parties undertake different activities in which they have different rights and obligations relating to the different activities. Management should take care when considering this approach and the inherent complexity and judgements in the eventual accounting, such as allocating the assets and liabilities between the parties.

**One framework, two arrangements?**

Three parties might establish joint control over a refinery in a legal entity. The three parties, A, B and C have shareholdings of 35%, 35% and 30% respectively, in the legal entity. A and B provide crude oil to the refinery and each is obligated to take 50% of the refined products. C operates the refinery and receives a management fee for its services. The refined products are priced to such that the cash flows will cover operating expenses and sufficient cash to pay C's management fee. There may be a joint operation that encompasses the refining activity and refinery assets between A and B and a joint venture between A, B and C for the operations of the refinery.

### *Re-assessment of classification*

The decision on classification is subject to continuous reassessment, and classification could change over time. The change could be an expected one, as different contractual arrangements are triggered as the activities of the arrangement change or it could arise because the parties agree changes to the existing contracts. For example, a joint arrangement in the exploration and development phase may fund this phase though cash calls from the parties to the arrangement and therefore be classified as a joint operation. Once in production, the parties change the contractual terms and sell a substantial portion of the output to third parties, and the joint arrangement is no longer dependent on the parties for its cash flows; thus the classification changes to joint venture.