

Managing the risk: Joint Venturing

The impact of the new joint arrangements and consolidation standards

Refining IFRS

Mining and metals

What you need to know

- ▶ IFRS 10 has a new definition of control and provides additional guidance that could impact any previous assessments of control and joint control
- ▶ IFRS 11 describes the accounting for arrangements in which there is joint control; proportionate consolidation is not permitted for joint ventures (as newly defined)
- ▶ IFRS 12 requires new and expanded disclosures for joint arrangements, as well as for subsidiaries, associates and structured entities, which will impact processes and systems

The search for growth is leading mining and metals entities to increase their appetite for risk. This is manifesting itself by bringing in partners to source new projects, improve utilisation of expensive infrastructure, help manage technical or political risk or comply with local regulations. To this end joint arrangements have always been and continue to be a common structure in the mining and metals sector. The majority of mining and metals entities are party to at least one joint arrangement. In fact, in the five-month period ending May 2011, 49% of all M&A transactions within the sector involved projects with multiple parties (Source: Thomson Financial LLP and Ernst & Young analysis).

However, for some joint arrangements, the accounting is about to change significantly, and not all arrangements commonly described as 'joint ventures' or 'joint arrangements' will continue to be accounted for as in the past, so careful assessment will be required.

What's happened?

The International Accounting Standards Board (IASB) recently issued a new standard - IFRS 11 *Joint Arrangements*. Simultaneously, it also issued two other new standards - IFRS 10 *Consolidated Financial Statements* and IFRS 12 *Disclosure of Interests in Other Entities*. These new standards are effective for annual periods beginning on or after 1 January 2013, and must be applied retrospectively.

In this publication, we provide a high level overview of some of the implications of IFRS 10 and IFRS 11 specific to the mining and metals sector. For a more detailed consideration of the implications of the new standards, additional publications are available at www.ey.com/IFRS.

What's the impact?

- ▶ A confusing part of the changes is the use of terminology within the new standards. The way in which a number of common terms are now being defined may not be obvious
- ▶ Some proportionately consolidated jointly controlled entities (JCEs) may now be classified as joint ventures and will have to be accounted for using the equity method
- ▶ Conversely, some equity accounted JCEs may now be classified as joint operations and the joint operator will recognise its assets, liabilities, revenues and expenses and/or its relative share thereof
- ▶ These changes will impact the presentation of financial statements, and 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

1. Overview

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. It is important that entities understand the implications and interplay of both IFRS 10 and IFRS 11 to ensure the proper assessment of, and accounting for, current and future joint arrangements.

2. Clarifying the confusion – new terms, new concepts

IFRS 11 has taken some commonly used terms and given them new specific meanings. This is already causing considerable confusion. For example, what many in the sector would refer to as joint ventures are now collectively referred to as 'joint arrangements'; the term 'joint venture' is now narrowly defined in IFRS 11.

Likewise, the term 'proportionate consolidation' has been (and still is) used to casually describe all methods of joint venture accounting where an entity recognises its share of the assets and liabilities of the joint venture. However, from an accounting perspective, this term now means something quite specific and is not reflective of the accounting treatment that currently applies to jointly controlled assets (JCAs) and jointly controlled operations (JCOs) under IAS 31; and that which will now apply to joint operations under IFRS 11.

What's in a name?

Old	New
Joint venture	Joint arrangement
Jointly controlled asset / Jointly controlled operation	Joint operation
Jointly controlled entity / incorporated joint venture	Either** - Joint operation or - Joint venture
Equity accounted joint venture	Joint venture
Proportionate consolidation	<i>No longer permitted for joint ventures (as defined)</i>
Venturer / Joint venturer	Joint venturer or Joint operator

** Depends upon classification under IFRS 11

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 - this is not correct.

3. New definition of joint control

Joint control is now defined as "... *the contractually agreed sharing of control of an arrangement which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control.*" The key aspects of joint control are:

- ▶ *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 (which are those activities that significantly affect the returns of the arrangement)
- ▶ *Unanimous consent* - exists when the parties to an arrangement have collective control over the arrangement, but no single party has control

The new requirements of this definition relate to the assessment of control and relevant activities. Unanimous consent is not new, however, additional guidance has been added to clarify when this exists.

3.1 Determination of control – impact of changes to the consolidation standard

It is common in the mining and metals sector for one of the parties to be appointed as the operator / manager of the joint arrangement ('the operator'), to whom some of the decision-making powers might be delegated. Currently, many consider that the operator simply carries out the decisions of the parties under the joint venture (or operating) agreement (JOA), i.e., acts as an agent. Under the new standards, it may be concluded that the operator controls the joint arrangement. This is because when decision-making rights have been delegated, IFRS 10 provides new requirements on how to assess whether an entity is acting as principal or agent. This is used to determine which party has control.

Careful consideration will be required to assess whether an operator acts as principal (and, therefore, may actually control the arrangement) or as agent. We consider the impact of controlling an arrangement in section 3.1.1. Where the operator is an agent, it only recognises its interests in the joint arrangement (the accounting for which will depend upon whether it is a joint operation or joint venture) and its operator/management fee.

3.1.1 So what happens if you have control?

The impact of controlling an arrangement will depend upon a number of factors. The most important of these will be identifying and assessing the rights and obligations the contractual arrangement provides the parties.

Where the arrangement provides the operator with rights to, and obligations for, the underlying assets and liabilities of the arrangement, it does not control anything over and above its own direct interest in those assets and liabilities. Therefore, it still only recognises its interest in those assets and liabilities. This accounting applies regardless of whether the arrangement is in a separate vehicle¹ or not. However, where the operator has rights to the net assets of the arrangement, it consolidates the arrangement and recognises any non-controlling interest.

The other factor to consider is whether the arrangement is a business, as this determines whether, upon obtaining control, the requirements of IFRS 3 *Business Combinations* apply.

How we see it

While certain aspects of joint control are unchanged from IAS 31, care is required in determining whether the arrangement is still considered to be under joint control under IFRS 11. This is because 'control' in the new definition of 'joint control' is now based on the new definition of control in IFRS 10.

3.2 'Unanimous consent' – what does this mean?

While the requirement for unanimous consent is not new, IFRS 11 provides additional guidance that clarifies when unanimous consent exists, and over which activities it is required. Unanimous consent means that any party with joint control can prevent any of the other parties, or a group of parties, from making a unilateral decision about relevant activities.

To have joint control, unanimous consent is required for decisions about the relevant activities. If the requirement for unanimous consent relates only to decisions that give a party protective rights², or over administrative matters only, and not to decisions about the relevant activities, that party does not have joint control. For example, a veto right that prevents a joint arrangement from ceasing business would likely be a protective right, and not a right that creates joint control. However, if the veto rights relate to relevant activities, then those rights may create joint control.

¹ IFRS 11 defines a separate vehicle as "A separately identifiable financial structure, including separate legal entities or entities recognised by statute, regardless of whether those entities have a legal personality."

² IFRS 10 defines protective rights as those designed to protect the interests of the party holding those rights without giving that party power over the entity to which those rights relate and that relate to fundamental changes to the activities of an investee or apply in exceptional circumstances.

IFRS 11 provides some examples to illustrate this point:

	Example 1	Example 2	Example 3
Requirement	75% vote to direct relevant activities	75% vote to direct relevant activities	Majority vote to direct relevant activities
Party A	50%	50%	35%
Party B	30%	25%	35%
Party C	20%	25%	n/a
Other	n/a	n/a	Widely dispersed
Conclusion	Even though A can block any decision, A does not control the arrangement, because A needs B to agree - therefore, there is joint control between A and B.	No control (or joint control) because multiple combinations could be used to reach agreement	No control (or joint control) because multiple combinations could be used to reach agreement

How we see it

The new (and clarified) requirements for assessing whether unanimous consent is required over relevant activities may mean some arrangements that have previously been assessed as having joint control now no longer satisfy the requirements. Hence, these will not be considered joint arrangements.

4. Differences between joint ventures and joint operations

Once it has been established there is joint control, joint arrangements are then classified as either: joint operations or joint ventures.

4.1 Joint operations

JCAs and JCOs: These are now called 'joint operations' under IFRS 11. The accounting for these arrangements will generally be the same as under IAS 31. That is, the joint operator (now 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 shares of those items, if any. As mentioned previously, this accounting is often incorrectly referred to as proportionate consolidation, when in fact it is not. We consider this issue later in this publication.

JCEs - rights to assets and obligations for liabilities: It is also possible that current JCEs may be classified as joint operations. Regardless of legal structure, where 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, and accounted for as above.

4.1.1 Does IFRS 3 apply to joint operations?

One area where there is currently a lack of clarity when accounting for acquisitions of interests in JCAs and JCOs, is whether the principles of IFRS 3 will apply. Unless this issue is resolved, it will present similar issues for joint operations.

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 be a business, the venturer/joint operator does not control that business - they only have 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 JCA/JCO or joint operation, and the entity controls this. This lack of clarity has led to diversity in practice. This issue was recently referred to the IFRS Interpretations Committee and was considered at their July 2011 meeting. At the date of this publication, this issue was still being considered.

How we see it

Our experience shows that practice in this area is indeed diverse and there are varying views as to whether IFRS 3 should or should not apply. It will not be a simple exercise for the IFRIC to resolve and significant research and outreach will be required.

4.2 Joint ventures

JCEs - rights to net assets: In this instance, the arrangement will be classified and accounted for as a joint venture. 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 account for this investment. Proportionate consolidation is no longer permitted for joint ventures.

It is important to note that not all current JCEs will automatically be considered joint ventures under IFRS 11 - detailed analysis will be required.

4.3 Clarifying the accounting: What is proportionate consolidation?

As mentioned earlier, there is some misunderstanding as to what proportionate consolidation is, and how this compares to JCA/JCO accounting under IAS 31, and the accounting for joint operations under IFRS 11. As a consequence, there is some unwarranted concern that all interests in joint arrangements will require equity accounting - which is not the case. And for JCEs that are classified as joint operations under IFRS 11, it may not be apparent how the adoption of IFRS 11 may impact the financial statements. Example 1 illustrates how these two accounting methods may differ in certain circumstances.

Example 1: 50% / 50% joint arrangement

Item	100% amount	Proportionate consolidation		IAS 31 - JCA/JCO accounting IFRS 11 - JO accounting	
		Party A	Party B	Party A	Party B
Truck*	200	100	100	200	-
EE&D	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 JCAs/JCOs.

4.4 The impact of a change in classification upon transition

JCE (proportionate consolidation) to joint venture: Where proportionate consolidation was previously used for JCEs and such arrangements are now classified as joint ventures, the transition to equity accounting will result in substantial changes to the financial statements of the joint venturer. These changes will include presentation changes, for example going from multiple line items throughout the financial statements to single line items; and in some instances there may also be measurement differences. For example, any losses from a joint arrangement would have been recognised as incurred when using proportionate consolidation. Under equity accounting, such losses are only recognised to the point at which the investment in the joint arrangement is reduced to nil.

JCE (proportionate consolidation) to joint operation: As explained above (and illustrated in example 1), it is also possible that for proportionately consolidated JCEs which are now considered joint operations, the accounting may not be identical. This will occur where an entity does not have a uniform percentage interest in all assets and liabilities.

How we see it

As a result of the changes introduced by IFRS 11 to classify a joint arrangement, we would caution entities against voluntarily changing from proportionate consolidation to the equity method, while still reporting under IAS 31. Such a decision can only be made after entities have fully analysed the classification under the new standard.

5. Gross versus net – what should I recognise?

It is clear that a participant in a joint operation is required to recognise its rights to the assets, and its obligations for the liabilities (or share thereof), if any, of the joint arrangement. Therefore it is important that an entity fully understands what these rights and obligations are and how these may differ between the parties.

Operators of joint arrangements may have a direct legal liability in respect of the entire balance of certain obligations arising from transactions related to the joint arrangement. They may also have a right of reimbursement (by virtue of the JOA) from the non-operator parties. 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. That is, assuming they can demonstrate that the non-operator is able and willing to pay their share. IFRS prohibits the offsetting of these liabilities against these receivables, unless specific requirements are met.

In addition to gross versus net considerations, it is also possible that there may be liabilities in the arrangement where the obligation is joint and several. A common example of this in the mining and metals sector is rehabilitation obligations. Here each party not only takes up its proportionate share of the rehabilitation obligation, it is also required to assess the likelihood that the other party will not be able, or willing, to meet their share. Where there are doubts, there may be additional disclosure requirements e.g., contingent liability disclosures, or a requirement to recognise an additional provision.

How we see it

In many instances, the requirement for an operator to recognise 100% of certain liabilities, and then a separate receivable from the non-operator parties, and similarly the accounting for joint and several liabilities, will not negatively impact the operator's (or entity's) net asset position.

Furthermore, recent events illustrate that non-operator / other parties may not always be able, or willing, to meet their share of obligations of the joint arrangement.

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

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

Where the arrangement provides the party with rights to, and obligations for, the underlying assets and obligations, it continues to recognise its interest in those assets and liabilities. This accounting applies regardless of whether the arrangement is in a separate vehicle or not.

However, where the arrangement provides the party with rights to the net assets, the party will have to consider whether it has significant influence over the arrangement. If so, it accounts for its interest in accordance with IAS 28 *Investments in Associates and Joint Ventures (as amended in 2011)* - equity accounting; otherwise it accounts for its interest under IAS 32/IAS 39 or IFRS 9.

How we see it

Given that the accounting for these contractual arrangements is impacted by 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 their rights and obligations.

7. 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 an arrangement structure 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 the immaterial joint ventures. All of these will impact an entity's processes and systems.

8. Final thoughts

The rights and obligations provided to a party under these contractual arrangements will drive the eventual accounting under IFRS 11.

Given the unique nature of the various types of arrangements that currently exist, and are emerging, an entity will need to individually analyse each arrangement to be able to complete this assessment. The difficulty of this task will be impacted by the number and complexity of the arrangements to which an entity is a party. 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.

IFRS contact

Tracey Waring
Global Mining & Metals IFRS Leader
Tel: +44 20 7980 0646

tracey.waring@uk.ey.com

Ernst & Young's Global Mining & Metals Center

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Area contacts

Global Mining & Metals Leader

Mike Elliott
Tel: +61 2 9248 4588
michael.elliott@au.ey.com

Oceania

Scott Grimley
Tel: +61 3 9655 2509
scott.grimley@au.ey.com

China

Peter Markey
Tel: +86 21 2228 2616
peter.markey@cn.ey.com

Japan

Kentaro Nakamichi
Tel: + 81 3 5401 6407
kentaro.nakamichi@jp.ey.com

Europe, Middle East, India and Africa Leader

Mick Bardella
Tel: +44 20 795 16486
mbardella@uk.ey.com

Africa

Adrian Macartney
Tel: +27 11 772 3052
adrian.macartney@za.ey.com

Commonwealth of Independent States

Evgeni Khrustalev
Tel: +7 495 648 9624
evgeni.khrustalev@ru.ey.com

France and Luxemburg

Christian Mion
Tel: +33 1 46 93 65 47
christian.mion@fr.ey.com

India

Anjani Agrawal
Tel: +91 982 061 4141
anjani.agrawal@in.ey.com

United Kingdom & Ireland

Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Americas and United States Leader

Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Canada

Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

South America and Brazil Leader

Carlos Assis
Tel: +55 21 2109 1606
carlos.assis@br.ey.com

Service line contacts

Global Advisory Leader

Paul Mitchell
Tel: +86 21 22282300
paul.mitchell@cn.ey.com

Global Assurance Leader

Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

Global IFRS Leader

Tracey Waring
Tel: +44 20 7980 0646
tracey.waring@uk.ey.com

Global Tax Leader

Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Global Transactions Leader

Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

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