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# RIC – öffentliche SITZUNGSUNTERLAGE

| **RIC-Sitzung:** | **43. / 11.11.2010 / 13:15 – 15:30 Uhr** |
|---|---|
| **TOP:** | **08 – Request for Input**<br>– Risk Sharing Arrangements in Extractive Industries<br>– Events that occur after the date of authorisation |
| **Thema:** | **Risk Sharing Arrangements in Extractive Industries** |
| **Papier:** | **08_2_RfI_Risk_Sharing_Arr** |

## Vorbemerkung

1 Auf den nachfolgenden Seiten wird die von einem nationalen Standard Setzer (NSS) vorgelegte Anfrage ohne inhaltliche Änderungen wiedergegen. Es wurden lediglich Hinweise auf die Identität des NSS unterbunden.

**Risk Sharing Arrangements in Extractive Industries**

Frequently, extractive companies (including oil and gas companies) enter into "farm-out" or "risk sharing" arrangements. A farm-out arrangement involves an entity ("the farmor") agreeing to provide a working interest in an oil and gas property to a third party ("the farmee") provided that the farmee performs certain work on the property (e.g. if the farmee agrees to drill 4 wells they would receive a 30% interest in the property's production and would, upon earning their working interest, generally be given joint control over the operation of the property).

In practice there are many variations to farm-out arrangements and these arrangements are typically complex. For purposes of this enquiry we are restricting the transaction to one involving a property outside the exploration and evaluation stage, in other words outside the scope of IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

The issue is whether a farm-out arrangement, from the perspective of the "farmor" entity, should be accounted for as the derecognition of part of the property and whether this results in the recognition of a gain or loss.

We provide below a simple example of a "farm out" transaction.

**Entity A**

- Carrying Value of Property before farm-out = € 100 M
- Farm out arrangement – a 30% interest will be earned by Entity B if Entity B drills 4 wells (Value of 4 wells = € 20 M)
- Fair Value of the Property after farm-out = € 250M
- Entity A's 70 % share of the property after the farmee completes its part of the obligation under the farm-out arrangement is valued at = € 175M (70% of € 250 M)

Before the farm-out arrangement Entity A has a direct 100% interest in the producing oil and gas property. When Entity B completes its obligations under the farm-out arrangement it has earned an interest of 30% and has joint operating control over the property (i.e. all key decisions need to be unanimously approved by an operating committee consisting of entity A and B).

We aware of a number of views on the treatment of "farm-out" arrangements – see Appendix.

**We would appreciate your input on how entities in other jurisdictions applying IFRSs have treated this type of transaction.**

1. **Would entities in your jurisdiction de-recognize a portion of the property on Entity A's records on which the work is being done?**

   a) **If yes, under what basis of accounting?**

   b) **If not, how is the transaction recorded and under what basis of accounting?**

## APPENDIX

**These possible accounting treatments are provided below for your information only. They may or may not be similar to the treatment being used in your jurisdictions**

### View A – IAS 27 applies

Proponents of this view believe that a subsidiary in IAS 27 *Consolidated and Separate Financial Statements* is defined broadly to include both incorporated and unincorporated "entities" and thus the rules regarding loss of control in IAS 27 would apply. Paragraph 34 of IAS 27 indicates that when control over a subsidiary is lost, the entity should recognize its retained interest in the former subsidiary at fair value at the date control is lost.

For purposes of this view it is assumed that the property meets the definition of a business in IFRS 3 *Business Combinations* (as issued in 2008): An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

If the oil and gas property that Entity A owned outright is considered to be a business as defined by IFRS 3, the completion by Entity B of its obligation (the 4 wells are drilled) results in Entity A losing control over that business. Entity A after the loss of control is left in a position of joint control with Entity B. Therefore, Entity A would derecognize the portion of the property it no longer owns and recognize the retained interest in the former subsidiary at fair value as follows:

| | | |
|---|---|---|
| DR Property | € 75M | |
| CR Gain | | € 75M |

{Recognizes the fair value of the 70% share of the business retained after the farm out arrangement is completed of € 175 and derecognizes the carrying amount of the property of € 100 M}

### View B – IAS 16 applies

Proponents of this view consider that although control is lost over the property, the property is an asset and not a "subsidiary". Therefore, the rules in IAS 27 relating to loss of control do not apply to this situation of direct ownership. Although, IAS 16 *Property, Plant and Equipment* provides guidance for dispositions of property in their entirety, it does not address the disposal of an undivided interest in a property where an economic benefit remains with the owner. Nevertheless, proponents of this view would recognize a disposition of a partial interest in the property as follows:

| | | |
|---|---|---|
| DR Property | € 14M | |
| DR Loss on Disposal | € 16M | |
| CR Property | | € 30M |

{Derecognize a 30% interest in previous carrying amount of the property of € 100M and recognize the drilling services received at the proportionate share in the cash expended 70% of € 20M}

**View C –Account for the Formation of a Joint Venture**

Prior to the farm-out transaction, Entity A owned the property outright and had full decision making control. Subsequent to the farm out transaction Entity A has joint control over the asset/business. Under this view after the farmee completes its obligation, which results in Entity A and B having joint operating control over the property (i.e. all key decisions need to be unanimously approved by an operating committee consisting of entity A and B), the arrangement could be accounted for in accordance with IAS 31 *Interest in Joint Ventures.*

Proponents of this view would note that depending on the arrangement it could be accounted for as a jointly controlled operation or as a jointly controlled asset.

However in the example provided, it is assumed that once Entity B completes its obligation and has earned its interest of 30%, the assets are transferred in to a jointly controlled entity. Accordingly, the contributions of the assets to a joint venture (even where these are businesses for which the contributing entity has lost control) are accounted for under SIC 13 *Jointly Controlled Entities — Non-Monetary Contributions by Venturers*. SIC 13 permits the entity to recognize the gain or loss only to the extent of the interest of the other venturers.

**NOTE**: SIC 13 only allows for partial recognition of the gain or loss relative to the full recognition of any gains and losses that would result under IAS 27. This issue has been discussed by the IASB on a number of occasions and the IASB Staff Paper 11B for the December 2009 describes the difference in detail. However, the IASB has not yet decided how to rectify the inconsistency between the two pronouncements.

**View D – Do not recognize gains and losses relating to farm-out transactions**

Proponents of this view note that IAS 16 does not address specifically the disposal of an undivided interest in a property where an economic benefit remains with the owner. Therefore, holders of this view believe the entity should develop an accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Through analogy to US GAAP, the policy an entity adopts may be to make no entry on a farm out transaction (or if cash is received directly to net it against the carrying value of the property).

**View E – Recognition of gains/losses depends on specific facts and circumstances**

There may be circumstances where neither the fair value of the property given up nor the proceeds received are reliably measureable and therefore IAS 16.24 would allow the value of the drilling received to be measured at the cost of the property given up. That is, no gain or loss would be recognized.

Measurability could be affected if:

- The proceeds are viewed as the fair value of the results of drilling and not its costs.
- The costs of drilling are not known by the farmor nor are they estimable.
- Eligible costs to be incurred by the farmee include general and administrative. type costs that would not ordinarily be capitalized (e.g. where the farmee must spend €30M to earn its interest and part of this € 30M can be general and administrative in nature).