VIEWPOINTS:
Applying IFRSs in the Oil and Gas Industry

IFRS 11 AND DIRECT WORKING INTERESTS

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Background

IFRS 11 *Joint Arrangements* prescribes the accounting for a joint arrangement, which is defined as a contractual arrangement over which two or more parties have joint control.

There are two classifications of joint arrangements under IFRS 11:

- **Joint Operation**—A joint operation is an arrangement in which the jointly controlling parties have rights to assets and obligations for liabilities relating to the arrangement.
- **Joint Venture**—A joint venture is a joint arrangement in which the jointly controlling parties have rights to the net assets of the arrangement.

For more information on IFRS 11 *Joint Arrangements* refer to the CPA Canada website.

Issue

How should a company account for its interest in a joint arrangement that is not structured through a separate vehicle (e.g., direct working interest in a well)?

Oil and Gas Industry Task Force on IFRSs

Canada's move to International Financial Reporting Standards (IFRSs) creates unique challenges for junior oil and gas companies. Financial reporting in the sector is atypical due to significant differences in characteristics between junior oil and gas companies and other types of companies. The Canadian Association of Petroleum Producers (CAPP), The Explorers and Producers Association of Canada (EPAC) and the Chartered Professional Accountants of Canada (CPA Canada) created the Oil and Gas Industry Task Force on IFRSs to share views on IFRS application issues of relevance to junior oil and gas companies. The task force views are provided in a series of papers that are available through free download. These views are of particular interest to chief financial officers, controllers and auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by the CAPP, EPAC, CPA Canada or the organizations represented by the task force's members.

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Viewpoints

Joint Control Assessment

Prior to determining the appropriate accounting for an arrangement, an entity must first determine if the arrangement falls within the scope of IFRS 11.

IFRS 11 applies only to entities that are a party to a joint arrangement—an arrangement where two or more parties have "joint control."[1]

Joint control is the contractually agreed sharing of control of an arrangement. It exists only when decisions about the relevant activities of the arrangement require the unanimous consent of the parties sharing the control of the arrangement. For this purpose, "relevant activities" are as defined in IFRS 10 *Consolidated Financial Statements* being activities of the arrangement that significantly affect its returns.

In other words, for a joint arrangement to exist, a group of the parties to the arrangement must 1) have collective control of the arrangement and 2) share that control jointly.

Determining if joint control exists is not always straightforward. Consider, for example, a scenario where three unrelated parties, Oil-X Co., Oil-Y Co., and Oil-Z Co., establish an arrangement where the parties have 50, 25, and 25 per cent of the voting rights in an arrangement, respectively. The contractual arrangement specifies that at least 75 per cent of the voting rights are required for decisions about the relevant activities. Based on these facts, it is likely that joint control does *not* exist unless the contractual arrangement among the parties specifies which combination of parties is required to agree about decisions in respect of the relevant activities.

If joint control does *not* exist then the arrangement is not within the scope of IFRS 11. As a result, the accounting for such an arrangement would follow other relevant IFRSs—an entity would recognize its own assets, liabilities and transactions in accordance with the relevant IFRS (e.g., IAS 16).[2]

Classification Assessment

A joint arrangement that is *not* structured through a separate vehicle is a joint operation. In such cases, the contractual arrangement establishes the parties' rights to the assets, and obligations for the liabilities, relating to the arrangement, and the parties' rights to the corresponding revenues and obligations for the corresponding expenses.

Accounting for a Joint Operation

A party to a joint operation (i.e., joint operator) recognizes its own assets, liabilities and transactions, including its share of those incurred jointly. In other words, each party to the joint operation accounts for its share of the joint assets and its agreed share of any liabilities, and recognizes its share of revenues and expenses in accordance with the contractual arrangement.

1 An arrangement can be a joint arrangement even when not all of its parties have joint control of the arrangement. IFRS 11 distinguishes between parties that have joint control of a joint arrangement (joint operators and joint ventures) and parties that participate in, but do not have joint control of, a joint arrangement (those parties hold a simple investment).

2 A party that participates in, but does *not* have joint control of, an arrangement that *does* qualify as a joint operation (under the scope of IFRS 11) should account for its interest in the arrangement in the same way as a joint operator (i.e., recognize its own assets, liabilities and transactions).

As such, for direct working interests in a well (i.e., those working interests structured outside of a separate vehicle) the accounting would be similar under both scenarios—if joint control exists (i.e., the arrangement is a joint operation) *or* does not exist. In both cases, the party would recognize its share of assets, liabilities and transactions.

Acquisition of an Interest in a Joint Operation

In May 2014, the IASB amended IFRS 11 to provide specific guidance on accounting for the acquisition of an interest in a joint operation in which the activity constitutes a business, as defined in IFRS 3 *Business Combinations*. The amendments address diversity in practice related to the accounting for these transactions.

Joint Operation Constitutes a Business

When an entity acquires an interest in a joint operation that constitutes a business, it should apply, to the extent of its interest, the relevant principles of business combination accounting and related disclosure requirements in IFRS 3.

Consequently, such an entity would:

- measure identifiable assets and liabilities at fair value with exceptions;[3]
- recognize acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with the exception that the costs to issue debt or equity instruments are recognized in accordance with IAS 32 *Financial Instruments: Presentation* and IFRS 9 *Financial Instruments* (or IAS 39 *Financial Instruments: Recognition and Measurement*);
- recognize deferred tax assets and deferred tax liabilities that arise from the initial recognition of assets and liabilities, except for deferred tax liabilities that arise from the initial recognition of goodwill; and
- recognize any residual as goodwill or a gain from a bargain purchase.

All other principles of business combination accounting apply unless they conflict with IFRS 11.

The above guidance is applicable to the acquisition of both the initial interest and additional interests in a joint operation in which the activity of the joint operation constitutes a business.

Accounting for Step Acquisitions

No Change in Control

When the acquisition of an *additional* interest in the same joint operation results in the joint operator retaining joint control, the previously held interest is not remeasured.

Change in Control

IFRS 3.41–.42 gives explicit guidance for the acquisition of control over a business that is held through an *equity* interest, as opposed to a business that is held through *direct* interests in the assets and obligations for the liabilities of the business itself.

3 IFRS 3 requires the entity to measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values with limited exceptions; for example, deferred tax assets and deferred tax liabilities are not measured at fair value but are measured in accordance with IAS 12 *Income Taxes*.

Consequently, the question arises of whether a *previously* held interest in a joint operation is re-measured to its acquisition-date fair value on the acquisition of control over the joint operation. In particular, this question arises if the joint operation is not structured through a separate legal entity.

This question was discussed by the IFRS Interpretations Committee.[4] While the IFRS Interpretations Committee acknowledged that it was a valid issue, they believed it was best to consider this issue at some point in the future. Until such a time, the IFRS Interpretations Committee noted two approaches that are generally seen in accounting for the acquisition of control over a joint operation that is not structured through a separate vehicle.

1. **IFRS 3 Approach (i.e., Re-measurement Approach)**
   The previously held interest in the assets and liabilities of the jointly controlled operation is re-measured to fair value and the gain or loss arising on the re-measurement is recognized in the income statement.

   This view considers the previously held net interest in the assets and liabilities of the jointly controlled operation as previously held 'equity interest' and hence, it is re-measured to fair value. The substance of the transaction is that control has been acquired over a business and therefore the guidance under IFRS 3 is applied in its entirety.

2. **Modified IFRS 3 Approach**
   The previously held interest in the assets and liabilities of the jointly controlled operation is not re-measured to fair value. Instead it is recorded at the previous carrying value.

   Proponents of this approach consider the following factors as the basis for the view:
   a. Joint operations are generally not conducted through legal entities and hence there is no equity interest in a joint operation. Consequently, the requirement of IFRS 3 to re-measure the previously held equity interest to fair value does not apply; and
   b. Assets of a joint operation are already recognized on the balance sheet of the operator to the extent it controls those assets. On acquiring control over the jointly controlled operation, the operator has effectively acquired a further controlling interest over the assets of the jointly controlled operation. Consequently, it records the additional stake acquired at fair value but does not re-measure the previously held interest in the assets that it already controls.

Given the two approaches applied in practice, members of the *Oil and Gas Task Force on IFRSs* emphasize the importance of clear accounting policy disclosure to assist users in understanding how these transactions have been reflected in the financial statements.

To illustrate the above approaches the following example was presented in the **IFRS Interpretations Committee Meeting, Agenda Paper 13, IFRS 3 Business Combinations—Acquisition of Control over a Joint Operation, September 10–11, 2013**.

4 Based on extracts from the **IFRS Interpretations Committee Meeting, Agenda Paper 13, IFRS 3 Business Combinations—Acquisition of Control over a Joint Operation, September 10–11, 2013**.

Question

A7. Should the previously held interest in the assets and liabilities of a JO be re-measured to fair value and a gain or loss be recognised in the income statement when control is acquired over a JO?

Illustration

A8. There are three participants in a producing field which is a joint operation. The producing field represents a business as defined in IFRS 3. The ownership interest of the participants is as follows:

(a) Entity A 40%;

(b) Entity B 40%; and

(c) Entity C 20%.

A9. The terms of the joint operating agreement require decisions relating to financial and operating policies be approved by parties representing 75% of the interest in the arrangement. The carrying value of the asset in Entity A's financial statements is C 15 million.

A10. Entity A purchases Entity B's interest of 40% and obtains control. The fair value of the business is determined to be C 50 million. Entity A pays B consideration equivalent to its fair value of C 20 million.

A11. Entity A records this transaction as a business combination since it has acquired control over a producing field whose activities constitute a business.

A12. How should Entity A record the previously held interest of 40% in the assets and liabilities of the producing field?

IFRS 3 approach

(a) Entity A records the previously held interest of 40% in the assets and liabilities of the producing field at its fair value of C 20 million. A gain of C 5 million (being the difference between the carrying value of C 15 million and fair value of C 20 million) is recognised by Entity A in the income statement.

Modified IFRS 3 approach

(b) Entity A records the previously held interest of 40% in the assets and liabilities of the producing field at its carrying value of C 15 million. No gain or loss is recognised in the income statement.

Joint Operation Does Not Constitute a Business

When an entity acquires an interest in a joint operation that does not constitute a business, the acquisition is accounted for as an asset acquisition. In such cases, the entity should, to the extent of its interest, identify and recognize the individual identifiable assets acquired and liabilities assumed.[5]

Disclosure of Joint Operations

The disclosure requirements for entities involved with joint arrangements (such as a joint operation) are established in IFRS 12 *Disclosure of Interests in Other Entities*.

The objective of IFRS 12 is to require the disclosure of information that enables users of financial statements to evaluate the nature of, and risks associated with, its interests in other entities and the effects of those interests on an entity's financial position, financial performance and cash flows.

To meet this objective, an entity must exercise judgment in determining the appropriate nature and extent of disclosure.

Among other things, an entity should disclose:

- significant judgments and assumptions made in determining joint control and the type of joint arrangement (i.e., joint operation or joint venture);
- information about its interests in joint arrangements, to allow users to evaluate the nature, extent and financial effects of such interests, including the nature and effects of its contractual relationship with the other investors with joint control of, or significant influence over, joint arrangements.

An entity should refer to the disclosure requirements in IFRS 12 and consider the level of detail necessary to satisfy the Standard's overall disclosure objective. In meeting that objective, an entity should consider how much emphasis to place on each of the disclosure requirements. When

5 IFRS 3.2(b)

appropriate, an entity should aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of insignificant detail or the aggregation of items that have different characteristics.[6]

6 Where the disclosures required by IFRS 12, together with the disclosures required by other IFRSs, do not meet the above objective, an entity is required to disclose whatever additional information is necessary to meet the objective.

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