

ROUNDTABLE

CONSISTENT APPLICATION OF IFRS

BRUSSELS, 18 OCTOBER 2007

ISSUES PAPER PART 2

NOTICE TO THE PUBLIC

This paper has been compiled using written contributions from individual participants to serve as a basis for the discussions at the meeting of 18 October 2007. Any opinions or recommendations expressed in these paragraphs are those of the proposer(s) concerned and not the views of the Roundtable or of the Commission.

No interpretations of IFRS should be inferred from the contents of this paper.

ROUNDTABLE

CONSISTENT APPLICATION OF IFRS

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ISSUES PAPER PART 2

A. Brief overview of issues proposed

ISSUE 8 – IAS 28 ~ Recognition of dilution gain/loss arising from the sale or issuance of shares by an equity-accounted investee.

Proposed by: CESR

Company X prepares its financial statements in accordance with IFRS, as adopted by the European Union.

The consolidated financial statements of Company X include the following accounting policy in respect of capital transactions of a consolidated subsidiary or an equity-accounted investee: *“The Company recognizes dilution gains or losses arising from the sale or issuance of stock by **an equity-accounted investee in the income statement unless the Company either has reacquired or plans to reacquire such shares. In such instances, the result of the transaction will be recorded directly in equity as a non-operating gain or loss**”.*

The consolidated income statement of Company X includes a dilution gain as a result of the issuance of shares of an associate.

The question is where should the dilution gains or losses from the sale or issuance of shares by an equity-accounted investee be recognized according to IAS 28? Should it be in the consolidated income statement of the investor or in Equity?

ISSUE 9 – IAS 16 ~ IAS 38 - Accounting treatment of farm in/farm out arrangements in the oil extractive industry

Proposed by: CESR

A farm out (from the viewpoint of the transferor of an interest) or a farm in (from the viewpoint of the recipient) occurs when the owner of the operating rights in an oilfield (the farmor) transfers a part of that interest to a second party (the farmee) in return for the farmee's paying all of the costs, or only specified costs, to explore the property and perhaps to carry out part of or all of the development of the oilfield if reserves are found.

Farm in/out arrangements can occur in different stages of the field's development. They are most used in the earlier stages of exploration and development, but are also employed after the technical feasibility and commercial viability of a field has been demonstrated, and in some cases also after a field has started producing (e.g. in relation to development of satellite fields).

Do farm in / farm out arrangements constitute exchanges of non-monetary assets, and should they as such be accounted for according to IAS 16.24 / AIS 38.45?

B. Detailed description of issues proposed

ISSUE 8

IAS 28 - Recognition of dilution gain/loss arising from the sale or issuance of shares by an equity-accounted investee.

Proposed by: CESR

Issue

The question is where should the dilution gains or losses from the sale or issuance of shares by an equity-accounted investee be recognized according to IAS 28? Should it be in the consolidated income statement of the investor or in Equity?

Background

Company X prepares its financial statements in accordance with IFRS, as adopted by the European Union.

The consolidated financial statements of Company X include the following accounting policy in respect of capital transactions of a consolidated subsidiary or an equity-accounted investee: *“The Company recognizes dilution gains or losses arising from the sale or issuance of stock by **an equity-accounted investee in the income statement unless the Company either has reacquired or plans to reacquire such shares. In such instances, the result of the transaction will be recorded directly in equity as a non-operating gain or loss**”.*

The consolidated income statement of Company X includes a dilution gain as a result of the issuance of shares of an associate.

View 1 – In Equity

IAS 28.39 states that the investor’s share of changes recognised directly in the associate’s equity shall be recognised directly in equity by the investor. We therefore believe that this prohibits the investor to recognise dilution gains or losses arising from capital transactions by an equity-accounted investee in its consolidated income statement. Instead, we believe that dilution gains or losses should be recognized directly in equity.

IAS 28 does not provide any specific guidance on the accounting treatment by the investor of dilution gains or losses from the sale or issuance of shares by an equity-accounted investee. However, IAS 28.11 mentions some other examples of changes in the investee’s equity that have not been recognised in the investee’s profit or loss. These examples relate to revaluation of property, plant and equipment and foreign exchange translation differences.

View 2 – In P&L

A gain or loss on the dilution of an interest in an associate or jointly controlled entity should be recognised in profit or loss. This is because the dilution of an interest in an investee is equivalent to a direct disposal of the interest in the investee. Such a transaction is not a transaction with the equity holders in their capacity as equity holders, and therefore any resulting gain or loss should be recognised in profit or loss.

If such a dilution gain or loss would have been recognised directly in equity of the investor a subsequent sale of the associate or jointly controlled entity would still not

result in the recognition of this dilution gain or loss in profit or loss (profit on sale of the associate or jointly controlled entity does not include the gain or loss on dilution, because the cost price of the associate or jointly controlled entity has changed as a result of the dilution gain or loss). One could argue that this does not properly reflect economic reality.

Illustrative Example (calculation dilution gain)

Company A owns 30% of Company B.

Number of shares outstanding of Company B: 100

Equity of Company B: € 100

Company A's share in Company B: $30\% * € 100 = € 30$

B issues 20 new shares (to new investors) for € 40

Participation % Company A decreases to $30/120 = 25\%$

Equity of Company B: $€ 100 + 40 = € 140$

Company A's share in Company B: $25\% * € 140 = € 35$

Dilution gain: $€ 35 - € 30 = € 5$

ISSUE 9

IAS 16 - IAS 38 - Accounting treatment of farm in/farm out arrangements in the oil extractive industry

Proposed by: CESR

Issue

Do farm in / farm out arrangements constitute exchanges of non-monetary assets, and should they as such be accounted for according to IAS 16.24 / AIS 38.45?

Background

A farm out (from the viewpoint of the transferor of an interest) or a farm in (from the viewpoint of the recipient) occurs when the owner of the operating rights in an oilfield (the farmor) transfers a part of that interest to a second party (the farmee) in return for the farmee's paying all of the costs, or only specified costs, to explore the property and perhaps to carry out part of or all of the development of the oilfield if reserves are found.

Farm in/out arrangements can occur in different stages of the field's development. They are most used in the earlier stages of exploration and development, but are also employed after the technical feasibility and commercial viability of a field has been demonstrated, and in some cases also after a field has started producing (e.g. in relation to development of satellite fields).

During 2005 and 2006 an issuer has engaged in several arrangements in which interests in oil fields have been exchanged. These have both been swaps of interests in one oil field with interests in another oil field, and the type of farm in/out transactions referred to above. The pure license swaps have been accounted for as exchanges of non-monetary assets according to IAS 16.24, and gains and losses have been recorded.

The arguments for view 2 will be somewhat different whether it is a transaction before or after IFRS 6 came into force on January 1st 2006, The focus in this paper is forward looking. There does not seem to be a consistent IFRS practice among oil companies. Farm in / farm out arrangements are common and the accounting issue at hand is probably particularly important for the accounts of small and medium sized oil companies.

View 1

Farm in/out arrangements do not constitute non-monetary transactions in which ownership to part of an oil field is exchanged with future services and/or fixed assets related to the exploration and/or development of the field. Therefore, they are not exchanges of non-monetary transactions to be accounted for according to IAS 16.24.

Based on this conclusion, there seems to be no specific guidance in IFRS for how such arrangements are to be accounted for. After conferring with the hierarchy for selecting and applying accounting policies in IAS 8.10-12, one can identify specific guidance for accounting for farm in/out arrangements in both USGAAP (SFAS 19.44 & 19.47c - the arrangement viewed as pooling of assets) and UKGAAP (SORP 2001 paragraph 191-192). They both specify that under no circumstances may gains or losses be recorded in a farm in/out arrangement. Hence no gains or losses should be recognised.

View 2

Farm in/out arrangements constitute non-monetary transactions in which ownership to part of an oil field is exchanged with future services and/or fixed assets related to the exploration and/or development of the field. The corresponding accounting treatment depends on what stage of development the field is in:

- A. If such arrangements occur after investments in property, plant and equipment have been made in order to develop the field, the accounting for these assets included in the transaction is directly regulated by IAS 16.24.
- B. If such arrangements occur after the technical feasibility and commercial viability of a field has been demonstrated (which may be before any PP&E investments are made) the exploration and evaluation assets are no longer to be classified as such after (cf. IFRS 6.17). Hence these assets are hence no longer exploration and evaluation assets that are scoped out from IAS 16 and IAS 38 (cf. IAS 16.3 and IAS 38.2c). Farm in / farm out transactions involving such assets are directly regulated by IAS 16.24 and IAS 38.45.
- C. If such arrangements occur before the technical feasibility and commercial viability of a field has been demonstrated, the rights, exploration and evaluation assets are within the scope of IFRS 6, where no specific guidance to non-monetary exchanges is found. The question is then whether accounting practice should be developed by conferring with IAS 8.10-12 or only by applying IAS 8.10. Although IFRS 6 contains a temporary exception to the use of the full hierarchy, there is reason to believe that this exception only relates to the recognition and measurement issues particularly dealt with in IFRS 6, and not all issues relevant to the extractive industries (cf. scope of IFRS 6). By employing the hierarchy in IAS 8, cf. IAS 8.11a, the guidance in IAS 16.24 and IAS 38.45 is the most relevant accounting guidance.

Hence, each farm in/out agreement should be evaluated for commercial substance and whether fair value is measurable. If so, gains or losses should be recognised. Especially in the case of farm in / farm outs relating to oil fields in the early stages of development, the fair value may under certain circumstances prove to be unreliable.

Rationales for alternative accounting models for farm in/out arrangements in IFRS was discussed in the “Extractive Industries Issue Paper”, issued by IASC in November 2000, cf. paragraph 12.17-12.44. Those arguing that no gain or loss should be recorded viewed farm in / out arrangements as either pooling of assets made when establishing a jointly controlled asset/entity (cf. IAS 31 & SIC-13) or as exchanges of non-monetary assets (IAS 16 / IAS 38).

The accounting for exchange of non-monetary assets was part of the convergence project with FASB. Up to the end of 2004, APB 29 distinguished between exchange on similar and dissimilar assets, but due to the changes made in IFRS, SFAS 153 “Exchange of non-monetary assets” was issued. The principle rule was changed so that was identical to IAS 16.24. However, the standard contains explicit exceptions for such transactions in oil and gas producing companies, cf. SFAS 153.2. Hence, due to special exceptions, under USGAAP farm in/out arrangements in the oil industry will not give rise to gains and losses.

SORP 2001 (UKGAAP) was issued by The Oil Industry Accounting Committee. On their website one can find their analysis of the implications of IFRS implementation. In relation to farm in /farm out arrangements it says: “Taking the concept further, a carried interest or a farm-in might also be argued to represent an asset swap, potentially to be accounted for at fair value and resulting in the recognition of a gain or loss”.

As with many other issues discussed in the “Extractive Industries Issue Paper”, the accounting for farm in/out arrangements were not included in an industry specific standard in IFRS (IFRS 6). Hence, the accounting guidance for such arrangements must be sought in the general principles of IAS/IFRS standards. Although farm in/out arrangements are not specifically named in any particular IFRS standard (which is not to be expected in principle based accounting), farm in/out arrangements should be viewed as exchanges of non-monetary assets and treated according to IAS 16.24 and IAS 38.45.