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VIEWPOINTS:
Applying IFRSs in the Oil and Gas Industry

BACKGROUND

A common feature of certain transactions entered into by oil and gas entities, in particular exploration stage companies, is the issuance of units which comprise share capital ("shares") and share purchase warrants ("warrants") as elements of consideration for the transaction.

For example, an oil and gas company (the issuer) may enter into a financing arrangement requiring the issuance of warrants to investors (the holder(s)) as part of the transaction, making the financing arrangement more attractive to the investors. At the same time, warrants may also be issued to brokers or underwriters as consideration for services provided. It is also common for warrants to be issued in connection with other transactions, comprising part of the consideration for specified services, such as investor relations work.

In general terms, a warrant is an instrument that entitles the holder to buy an underlying security (e.g., share) of the issuing company at an exercise price within a certain time frame.

ISSUE

How should an oil and gas company (the issuer) account for share purchase warrants issued, both at the time of issuance and subsequently?

VIEWPOINTS

To determine the appropriate accounting for warrants by an issuer, it is critical to obtain a complete understanding of the nature of the transaction giving rise to the issuance as well as the specific terms and conditions of the warrants.

The nature of the transaction will determine whether the warrants issued are accounted for in accordance with:

- IFRS 2 *Share-based Payment* — Warrants issued in exchange for goods or services provided to the oil and gas company are generally within the scope of IFRS 2. IFRS 2 applies to share-based payment transactions with some exceptions.[1]

Oil and Gas Task Force on IFRSs

International Financial Reporting Standards (IFRSs) create 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 CAPP, EPAC, CPA Canada or the organizations represented by the task force members.

- IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement* — Warrants not issued in exchange for goods or services are generally within the scope of IAS 32/IAS 39.

The accounting guidance for instruments within each of these standards is different. For example, if the warrants are accounted for in accordance with:

- IFRS 2, a company determines if the warrants are i) an equity-settled award, or ii) a cash-settled award.[2] Following this determination, the company applies the specific recognition and measurement guidance in IFRS 2.
- IAS 32, a company determines if the warrants are i) equity, or ii) a financial liability. Following this determination, the company applies the specific measurement guidance in IFRS applicable to each classification.

Determining the nature of the transaction is especially important in situations where warrants, with the same terms and conditions, are issued concurrently to different parties. For example, in a public or private financing arrangement, identical warrants may be issued concurrently to investors as part of the financing transaction, as well as to brokers and underwriters (i.e., commonly referred to as "broker warrants") as compensation for their services provided.

WARRANTS FOR SERVICES PROVIDED

Oil and gas companies commonly issue warrants to external service providers such as brokers, underwriters or investor relation agencies.

Generally, such warrants are accounted for in accordance with IFRS 2 as they are issued for services provided to the oil and gas company and typically would not meet the scope exemptions in IFRS 2.[3]

Under IFRS 2, transactions in which external services are received as consideration for equity instruments of the company should be measured at the fair value of the goods or services received. Only if the fair value of the services cannot be measured reliably would the fair value of the equity instruments granted be used.

Illustrative Example: Warrants Issued for Services

Oil X Co. engages a broker to provide services relating to a public offering of units in Oil X Co.

Each unit comprises one common share and one warrant entitling the holder to purchase one common share at a fixed price by a future date. The warrants are required to be settled by the delivery of a fixed number of equity shares for a fixed price. No cash or net settlement options exist.

As compensation for the broker's services, Oil X Co. issues warrants to the broker. The fair value of the broker's services provided is $100,000.

This transaction with the broker is considered an equity-settled share-based payment transaction because Oil X Co. receives services as consideration for its own equity instruments. These warrants are considered equity-settled instruments and are accounted for under IFRS 2.

Illustrative Example: Warrants Issued for Services Continued…

The following journal entries are recorded by Oil X Co. (excluding tax consequences, if any):

Initial recognition & measurement

	Dr.	Cr.
Dr. Equity (Share Issuance Cost)	$100,000	
Cr. Equity (Warrant Reserve or Contributed Surplus)		$100,000

This transaction with brokers is in relation to a share issuance. As a result, the services provided relate to share issuance and share issuance expenses are included within equity.

Subsequent measurement
Under IFRS 2, equity-settled instruments are not subsequently re-measured (i.e., subsequent changes in fair value are not recognized).

Note: If warrants are accounted for in accordance with IFRS 2 *Share-based Payment,* the company determines if the warrants are i) an equity-settled award, or ii) a cash-settled award. As such, classification guidance under IAS 32 is not relevant (see below for further discussion).

WARRANTS WITHOUT SERVICES PROVIDED

As part of a financing arrangement, Canadian oil and gas companies commonly issue shares and warrants together as units to lenders or investors (e.g., in a public or private equity placement or as part of a convertible debenture financing arrangement).

Warrants not issued in exchange for goods or services are generally within the scope of IAS 32 and IAS 39.

To determine the appropriate accounting under IAS 32, an oil and gas company must carefully review the terms and conditions of the warrants to understand whether the warrants have characteristics of:

- a derivative financial liability (“financial liability”) that is measured at fair value, with changes in value recorded in profit or loss; or
- an equity instrument.

Although warrants are often settled by the issuance of equity shares, the warrants themselves may not necessarily be classified as an equity instrument. Under IAS 32, equity classification applies to instruments where a fixed amount of cash (or liability), denominated in the issuer’s functional currency, is exchanged for a fixed number of shares (often referred to as the “fixed for fixed” criteria). Warrants issued by oil and gas entities that fail to meet equity classification often contain terms that breach the “fixed for fixed” criteria in IAS 32.

The classification process is complex. However, some of the common features of warrants observed in Canada that may result in financial liability classification include, but are not limited to:

Feature	Example
• warrants with an exercise price based on the issuer’s market share price at the date of exercise	• Company A (the issuer) issues warrants with an exercise price dependent on Company A’s market share price at the date of exercise.
• warrants where the number of shares to be issued on exercise varies	• Company B issues warrants where the number of shares to be issued is based on the lowest five-day “Volume Weighted Average Price” in the last 30 days prior to exercise.
• warrants with an exercise price that is in a currency that is different from the functional currency of the issuer	• Company C (the issuer) has a U.S. dollar[4] functional currency and issues warrants that have an exercise price denominated in Canadian dollars.

The above list is not exhaustive. Other terms and conditions of warrants may exist, that may also result in financial liability classification. The analysis is very complex and involves professional judgment.

The classification of a warrant as an equity instrument or a financial liability can significantly affect a company's financial statements. For example, if a warrant is classified as a financial liability, it is subsequently measured at fair value with changes in value recorded in profit or loss, resulting in potential volatility within the financial statements (e.g., equity and profit or loss).

Consideration received on the sale of a share and share purchase warrant classified as equity is allocated, within equity, to its respective equity accounts on a reasonable basis. Two commonly accepted allocation approaches are the residual method and the relative fair value method.[5]

The allocation of consideration received on the sale of a unit comprising a common share and a share purchase warrant with the share purchase warrant classified as a financial liability can be more complicated. Please refer to the IFRS Discussion Group **website** for further discussion on this topic and page 7 for a listing of some other relevant IFRS Discussion Group topics.

Illustrative Example: Warrants Classified as Equity

To finance exploration activities, ABC Ltd. (the issuer), entered into a $1,000,000 private placement of units.

Each unit comprises one common share and one share purchase warrant in ABC Ltd. Each share purchase warrant has a fixed exercise price denominated in Canadian dollars and is convertible into a fixed number of shares. ABC Ltd. has a Canadian dollar functional currency. The fair value for the shares at the date of issue is $800,000.

The share purchase warrants are classified as equity instruments because a fixed amount of cash is exchanged for a fixed amount of equity. In this example, no other features exist that would result in financial liability classification.

Applying a residual approach, the following journal entries are recorded by ABC Ltd. (excluding tax consequences, if any):

<u>Initial recognition & measurement</u>

	Dr.	Cr.
Dr. Cash	$1,000,000	
Cr. Equity (Warrant Reserve or Contributed Surplus)		$200,000
Cr. Equity (Share Capital)		$800,000

<u>Subsequent measurement</u>
Warrants classified as equity instruments are not subsequently re-measured (i.e., subsequent changes in fair value are not recognized).

Illustrative Example: Warrants Classified as Financial Liabilities

To finance exploration activities, XYZ Ltd. entered into a $1,000,000 private placement of units.

Each unit is comprised of one common share and one share purchase warrant in XYZ Ltd. Each share purchase warrant has a fixed exercise price denominated in U.S. dollars and is convertible into a fixed number of shares. XYZ Ltd. has a Canadian dollar functional currency. At the date of issue, the share purchase warrants have a fair value of $400,000 Canadian dollars.

The share purchase warrants are classified as a financial liability. Although the conversion amount in foreign currency may be fixed, when converted back to XYZ Ltd.'s Canadian functional currency, it results in a variable amount of Canadian dollar denominated cash (that is, a variable carrying amount for the financial liability that arises from changes in exchange rates), and hence the instrument fails the "fixed for fixed" criteria for equity classification.

The following journal entries are recorded by XYZ Ltd. (excluding tax consequences, if any):

Initial recognition & measurement:

	Dr.	Cr.
Dr. Cash	$1,000,000	
Cr. Financial Liability		$400,000
Cr. Equity (Share Capital)		$600,000

Subsequent measurement (assuming an increase in value of warrants)

	Dr.	Cr.
Dr. Expense - Fair Value Movement	$XXX	
Cr. Financial Liability		$XXX

MEASUREMENT OF WARRANTS

The measurement or valuation of a warrant, which is analogous to a call option issued by a company, is frequently calculated using an option pricing model. A commonly used model is the Black-Scholes model.

Oil and gas companies, however, should exercise caution in automatically assuming that the Black-Scholes model is always appropriate and is the only valuation method that can be applied. For example, where a breach of the "fixed for fixed" requirement exists (as discussed above) and the warrants are classified as a financial liability, the use of different valuation models, possibly more complex in nature, may be appropriate.

A common issue highlighted by users of the Black-Scholes model relates to the model's underlying assumption that warrants can only be exercised at expiration, which may not always be the case with certain warrants. In addition, a key input into the Black-Scholes model is the implied volatility of the company's shares. For some junior oil and gas companies, basing the expected volatility on actual historical volatility may result in an unexpected (e.g., high) valuation. For example, some junior oil and gas entities may have low trading volumes. These companies may be more susceptible to a wide range of trading prices which in turn may create a high historical volatility number, contributing to a high warrant valuation (assuming all other factors remain constant).

Another valuation issue occurs when the valuation of the total unit, or in some cases simply the warrants, is greater than the transaction value. In these situations entities need to consider the restrictions on the recognition of day one gains or losses set out in IAS 39 and IFRS 13 *Fair Value Measurement*.[6]

MODIFICATION OF WARRANTS

Subsequent to the initial recognition of warrants, there may be instances where the original terms of the warrants are amended prior to, or near, maturity. For example, the amendment may take the form of an extension of the expiry date, a change in the exercise price or a combination of both.[7]

The accounting for a subsequent modification of the terms of the warrants depends on the initial classification of the warrants.

Assuming there is no evidence of any services being received on the subsequent re-pricing of the warrants, the following accounting guidance should be applied:

Initial Classification of Warrants		Guidance
IFRS 2 Within the scope of IFRS 2	Equity Settled	• Apply IFRS 2 guidance on modifications to equity-settled share-based payment arrangements. • Recognize an expense for any increase in the fair value of the equity instruments granted measured immediately before and after the modification. • Any decrease in value is not taken into account.
	Liability Settled	• Re-measure the fair value of the liability at the end of each reporting period, with any changes in fair value recognized in profit or loss for the period.
IAS 32 and IAS 39 Within the scope of IAS 32 and IAS 39	Equity Presentation	• The modification could be viewed as the cancellation of the old warrants followed by the issuance of new warrants. Subject to a company's accounting policy, a re-measurement adjustment, as a result of the amendments, may or may not be recognized within equity. • Note a change within equity may also result in an earnings per share adjustment.
	Liability Presentation	• Re-measure the financial liability based on the new terms of the warrants with any gain or loss recorded in the profit or loss.

EXERCISE OF WARRANTS

If a warrant holder exercises the option to convert the warrants into common shares of a company, the accounting for the exercise will depend on the classification of the warrant:

Initial Classification of Warrants	Guidance
Equity Presentation	• Amounts for warrants classified as equity instruments are transferred to another account within equity at the date the warrants are exercised.
Liability Presentation	• Amounts for warrants classified as a financial liability are revalued immediately prior to settlement. Any change in fair value is recognized in profit or loss.

EXPIRY OF WARRANTS

When shares prices are low, many warrants may expire unexercised. The accounting for unexercised warrants will depend on the initial classification of the warrant:

Initial Classification of Warrants	Guidance
Equity Presentation	• Amounts for warrants classified as equity instruments are generally transferred to another account within equity (e.g., Contributed Surplus) at the date the warrants expire.
Liability Presentation	• Amounts for warrants classified as a financial liability are revalued immediately prior to expiry and derecognized. Any change in fair value is recognized in profit or loss.

The expiration of warrants, however, may have tax consequences. A discussion of such tax consequences is outside the scope of this Viewpoint, but readers are encouraged to consult with their professional tax advisor.

OTHER SOURCES OF INFORMATION

To learn more about accounting for share purchase warrants, oil and gas companies may want to refer to the following IFRS Discussion Group reports, published on the Financial Reporting and Assurances Standards Canada **website**:

- *IAS 39: Measurement of a Unit Comprised of Common Shares and Warrants* — September 5, 2013
  The report considers the measurement of a unit comprised of common shares and warrants.
- *Modification of Share Purchase Warrants* — July 19, 2012
  The report considers the accounting treatment for a modification to the terms of warrants issued for proceeds including any effect on earnings per share.
- *Recognition of Share Purchase Warrants* — January 12, 2012
  The report considers which standard applies when warrants are issued to brokers or underwriters as consideration for the services provided in conjunction with an issuance of warrants or other securities.

Accounting for warrants can be complex and requires the exercise of judgment in arriving at an appropriate conclusion. Oil and gas companies should consider consulting their professional accounting advisors and auditors when undertaking such analysis.

(Endnotes)

1. Exceptions noted in IFRS 2 paragraphs 3A-6.
2. A cash-settled share-based payment transaction is a share-based payment transaction in which the entity acquires goods or services by incurring a liability to transfer cash or other assets to the supplier of those goods or services for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity. An equity-settled share-based payment transaction is a share-based payment transaction in which the entity receives goods or services a) as consideration for its own equity instruments (including shares or share options), or b) has no obligation to settle the transaction with the supplier.

   For cash-settled share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability. Until the liability is settled, the liability is remeasured at fair value at each reporting date (and the settlement date). Any changes in fair value are recognized in profit or loss for the period.
3. Exceptions noted in IFRS 2 paragraphs 3A-6.
4. Although the issue and repayment amount in foreign currency may be fixed, when converted back to the entity's functional currency, it results in a variable amount of cash (that is, a variable carrying amount for the financial liability that arises from changes in exchange rates), and hence fails the 'fixed-for-fixed' criteria for equity classification.
5. Under the residual method, one component is measured first and the residual amount is allocated to the remaining component. In contrast, under the relative fair value method the total proceeds of the instrument is allocated to the components in proportion to their relative fair values.
6. Refer to IAS 39.AG76-78, IFRS 13.57-60 and IFRS 13.BC132-138.
7. Often, an extension in the term and/or change in exercise price are made as a result of a decline in the entity's quoted share price below the warrant exercise price, which results in the exercise of the warrants being uneconomic to the holder. As a consequence of the modification, the fair value of the warrants will typically increase in comparison with the fair value immediately prior to the modification. The alternative to modification would be to allow the warrants to lapse, with the entity then attempting to raise new capital from investors.

The Oil and Gas Industry Task Force on IFRSs

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