Additional Exemptions for First-time Adopters

Project **Proposed amendments to IFRS 1**

Topic **Oil & gas issues**

Objective of this paper

1. The comment period for the Board's Exposure Draft *Additional Exemptions for First-time Adopters, Proposed Amendments to IFRS 1*, expired on 23 January 2009. That exposure draft proposed changes to IFRS 1 in respect of oil and gas assets, operations subject to rate regulation and leases. This paper will focus on the responses to the proposed changes to IFRS 1 in respect of oil and gas assets. Responses to the other issues will be discussed at the May Board meeting.

2. The paper identifies the main issues respondents raised on the oil and gas proposals and provides staff's recommendations.. The oil and gas proposals, marked up to incorporate staff's recommendations for changes from the exposure draft, are provided in Appendix A. A full list of issues raised on the oil and gas proposals and staff's analysis is provided in Appendix B.

Responses

3. A total of 95 responses were received to the exposure draft. Of these, 67 included comments on the oil and gas proposals. 35 responses expressing strong support for the proposals were received from Canadian oil and gas companies and one joint response also expressing strong support was received from seven major US full cost companies. Of the remaining 31 responses, 17 expressed support without

any suggestions for changes to the exposure draft proposals. 13 expressed overall support but identified suggested changes and one respondent did not support the proposed changes as the respondent did not feel they were necessary.

Issues raised

4. **Scope**. Some respondents questioned why the scope was limited to oil and gas activities and why it did not also apply to other situations where full cost was used. These respondents seemed concerned that there might be other situations where this exemption should also apply. However no specific examples of other industries were provided, either in the responses or in reply to staff's follow up request. Staff does not propose any change in scope.

5. **Full Cost.** Two respondents were concerned that there might be oil and gas companies with the same fact pattern but that did not use the term "full cost", and that the current wording might prevent them from using the exemption. These respondents suggested not using the term "full cost" in specifying which entities the proposed exemption would apply to. Instead the description of full cost in the footnote should be incorporated in the main text. While no specific examples have been provided of this situation, there does not seem to be any reason not to make this change. Staff recommends amending paragraph 19A accordingly. If the Board agrees to this, a similar change will be required in the Basis.

6. **Allocation**. Some respondents proposed that there be more specific guidance on the allocation methodology to be used for assets in the development and production phases. The intent of the exposure draft was to specify the general approach to allocation and then let management make the determination as to the appropriate detailed methodology to be used. Staff believes this will best meet the cost/benefit criteria discussed in paragraph BC26 of IFRS 1. Staff also does not believe there is any benefit in being prescriptive about the details of an allocation of the historic cost of oil and gas assets. Several respondents observed that users of oil and gas company financial statements are interested in cash flow and information on reserves and do not use the balance sheet historical cost amount.

7. However one of the responses indicated that the existing wording of the proposal could be interpreted to allow the costs for two or more separate cost centres to be aggregated and allocated over all the properties in those cost centres. Staff therefore recommends that paragraph 19A be modified to require the amount recorded in a cost centre under the entity's previous GAAP to be allocated to the underlying assets in that cost centre.

8. **Disclosure.** There were several suggestions for additional disclosure requirements to provide more detail on the allocation computations. Since this is an allocation of the balance sheet amount to specific assets and in general should not affect the amount reported in the statement of financial position, staff does not believe that detail about the computation will be of benefit to users. The allocation may lead to impairment of one or more assets, which would affect the amount reported in the statement of financial position. In this case IFRS 1 already requires disclosures about the impairment.

9. **Implementation guidance.** One respondent noted that paragraphs IG 8 and 9 should be amended to reflect the proposed changes. Staff agrees and the recommended changes are included in Appendix A

APPENDIX A: Proposed amendments to the Exposure Draft[1]

Exemptions from other IFRSs

13 An entity may elect to use one or more of the following exemptions:

(a) ...

(b) *deemed cost* (paragraphs 16–19B);

Deemed cost

19A Under some national GAAPs exploration and development costs for properties in development or production are accounted for in cost centres that include all properties in a large geographic area. (This is often referred to as full cost accounting). A first-time adopter using such accounting ~~full cost accounting*~~ under previous GAAP may elect to measure oil and gas assets at the date of transition to IFRSs on the following basis:

(a) exploration and evaluation assets at the amount determined under the entity's previous GAAP; and

(b) assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. The entity shall allocate this amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date.

The entity shall test exploration and evaluation assets and assets in the development and production phases for impairment at the date of transition to IFRSs in accordance with IFRS 6 *Exploration for and Evaluation of Mineral Resources* or IAS 36 *Impairment of Assets* respectively and, if necessary, reduce the amount determined in accordance with (a) or (b) above. For the purposes of this paragraph, oil and gas assets comprise only those assets used in the exploration, evaluation, development or production of oil and gas.

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[1] In November 2008 the IASB issued a restructured version of IFRS 1. The only effect on the proposed amendments is a renumbering of paragraphs and cross-references, which have not been included in this staff paper.

~~* Under full cost accounting, exploration and development costs for properties in development or in production are accounted for in cost centres that include all properties in a large geographical area.~~

25EA An entity that uses the exemption in paragraph 19A(b) (for oil and gas assets in the development or production phases accounted for using full cost accounting under previous GAAP) shall, instead of applying paragraph 25E or IFRIC 1:

(a) measure decommissioning, restoration and similar liabilities as at the date of transition to IFRSs in accordance with IAS 37; and

(b) recognise directly in retained earnings any difference between that amount and the carrying amount of those liabilities at the date of transition to IFRSs determined under the entity's previous GAAP.

Presentation and disclosure

Explanation of transition to IFRSs

Use of deemed cost for oil and gas assets

44B If an entity uses the exemption in paragraph 19A(b) for oil and gas assets, it shall disclose that fact and the basis on which carrying amounts determined under previous GAAP were allocated.

Effective date

47M An entity shall apply the amendments in paragraphs 13(b), 19A, 25E and 44B for annual periods beginning on or after ~~[date to be inserted after exposure]~~1 January, 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Proposed amendments to the Basis for Conclusions

Oil and gas assets

BC3 ~~On first-time adoption of IFRSs,~~Many oil and gas entities ~~that~~ accounted for exploration and development costs for properties in development or production in cost centres that include all properties in a large geographic area ~~used full cost accounting~~ under their previous GAAP. (This is often referred to as full cost accounting and this term will be used for purposes of this Basis.) These entities will in most cases have to determine the carrying amounts for oil and gas assets at the date of transition to IFRSs. Information about oil and gas assets recorded in an accounting system using full cost accounting will almost always be at a larger unit of account than the unit of account that is acceptable under IFRSs. Amortisation at the IFRS unit of account level would also have to be calculated (on a unit of production basis) for each year, using a reserves base that has changed over time because of changes in factors such as geological understanding and prices for oil and gas. In many cases, particularly for older assets, this information may not be available. The Board was advised that even if such information is available the effort and associated cost to develop the opening balances at the date of transition would usually be very high.

BC4 IFRS 1 permits an entity to measure an item of property, plant and equipment at its fair value at the date of transition to IFRSs and to use that fair value as the item's deemed cost at that date. Determining the fair value of oil and gas assets is a complex process that begins with the difficult task of estimating the volume of reserves and resources. When the fair value amounts included in the financial statements must be audited, significant inputs to the estimates generally require the use of qualified external experts. For entities with many oil and gas assets, the use of this fair value as deemed cost alternative would not meet the Board's stated intention of avoiding excessive cost (see ~~IFRS 1~~ paragraph BC41).

BC5 The Board ~~proposes~~ decided that, for oil and gas assets in the development or production phases, it would permit entities that used full cost accounting under their previous GAAP to determine the deemed cost at the date of transition to

IFRSs using an allocation of the amount determined under the entity's previous GAAP on the basis of the reserves associated with the oil and gas assets.

BC6 The deemed cost of oil and gas assets determined in this way may include amounts that would not have been capitalised in accordance with IFRSs, such as some overhead costs, costs that were incurred before the entity obtained legal rights to explore a specific area (and cannot be capitalized in accordance with IAS 38 *Intangible Assets*) and, most significantly, unsuccessful exploration costs that have been included in the full cost pool. This is a consequence of having included these costs in the single carrying amount under full cost accounting. To avoid the use of deemed costs resulting in an oil and gas asset being measured at more than its recoverable amount, the Board ~~proposes~~ decided that oil and gas assets should be tested for impairment at the date of transition to IFRSs.

BC7 Paragraph 25E of the IFRS exempts from the requirements of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* changes in decommissioning costs incurred before the date of transition to IFRSs. Use of this exemption would require detailed calculations that would not be practicable. The Board noted that adjustments to liabilities as a result of initial adoption of IFRSs arise from events and transactions before the date of transition to IFRSs and are generally recognised in retained earnings. Therefore, the Board ~~proposes~~ decided that any adjustment for a difference between decommissioning, restoration and similar liabilities measured in accordance with IAS 37 and the liability determined under the entity's previous GAAP should be accounted for in the same manner.

BC8 Not all oil and gas entities use the full cost method. Some use the successful efforts method. Successful efforts accounting requires a unit of account that is generally consistent with IFRSs and does not cause similar transition issues. Therefore, the Board ~~proposes~~ decided that this amendment to IFRS 1 would apply only to entities that used full cost accounting under their previous GAAP.

Implementation guidance

IG8 An entity may elect to use one of the following amounts as the deemed cost of an item of property, plant and equipment:

(a) fair value at the date of transition to IFRSs (paragraph 16 of the IFRS), in which case the entity gives the disclosures required by paragraph 44 of the IFRS;

(b) a revaluation under previous GAAP that meets the criteria in paragraph 17 of the IFRS; ~~or~~

(c) fair value at the date of an event such as a privatisation or initial public offering (paragraph 19 of the IFRS);~~.~~ or

(d) an allocation of an amount determined under previous GAAP that meets the criteria in paragraph 19A of the IFRS.

IG9 Subsequent depreciation is based on that deemed cost and starts from the date for which the entity established the ~~fair value measurement or revaluation~~deemed cost.

APPENDIX B: Analysis of responses to ED

ISSUE	COMMENT	CL #	STAFF ASSESSMENT	RECOMMENDATION FOR REVISED WORDING
General issues				
1. Amendments not necessary	Entities that have already adopted IFRSs have dealt with similar issues without the need for exemptions on first-time adoption of IFRSs.	4	The different circumstances related to entities in countries currently adopting IFRSs were discussed by the Board as part of approving the ED.	None
2. Adversely impact comparability between entities	Proposed amendments will reduce comparability between entities that already apply International Financial Reporting Standards (IFRSs) and entities that adopt IFRSs in the future. Given that the number of jurisdictions that have already adopted IFRSs is greater than the number of jurisdictions that are likely to adopt IFRSs in the future, the FRSB considers that it is not desirable to add additional exemptions for first-time adopters of IFRSs.	4	BC 10 of IFRS 1 states “it is more important to achieve comparability over time within a first-time adopter’s first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date: achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective.” Relatively few full cost companies have adopted IFRSs compared to the number of North American full cost companies. Based on research by the Extractives project team, users will not be concerned over any lack of comparability.	None

3. # of changes to IFRS 1	While welcoming the expanding number of jurisdictions adopting IFRSs, we are concerned with the frequency with which IFRS 1 is amended to address jurisdiction specific issues. Growing list of exemptions – lack of coherence – develop set of principles to evaluate proposed exemptions.	4 15	The proposed amendments to IFRS 1 for oil & gas address a significant issue faced by most oil & gas companies around the world that use full cost accounting.	None
Oil & Gas related comments				
4. Scope	Does this apply to tar sands? To material sourced from biological sources? Clarify in IFRS 1 and in Basis	15	Tar sands would clearly be included in the definition of oil and gas assets in paragraph 19A. However the proposed exemption would only be relevant if a company included tar sands assets in the same full cost pool as conventional oil & gas assets. Practice is to report tar sands as a separate segment. The ED wording is not explicit that the allocation in 19A(b) is for the assets and costs in a <u>single</u> cost centre and not a single allocation of the carrying amount of properties in several cost centres. Staff believes this should be clarified.	19A(b) assets in the development or production phases at the amount determined <u>for the cost centre</u> under the entity's previous GAAP.

			Material sourced from biological assets: these assets do not fit within the description of full cost accounting in the footnote to paragraph 19A. Staff does not recommend any changes to the ED to specifically address tar sands or biological assets.	 None
	Discussion in BC 5 and BC 6 suggests only capitalized costs that are not being amortised would be recorded at the amount determined under the entity's previous GAAP. Clarify this.	17	Neither paragraph 19A or BC 5 and 6 refer to amortization. The text of the proposed amendment and of the Basis are consistent in referring to "exploration and evaluation assets" and "assets in the development and production phases".	None
	Why is the exemption proposed for oil & gas and not mining or other industries that use full cost?	19 27	The issue of multiple properties having been accounted for in a single cost centre does not apply to mining or to other industries. Neither comment letter provides a specific example. Staff requested one respondent to provide an example and none was forthcoming. Staff enquiries have not identified any similar circumstances in other industries.	None
	Too industry specific	66 88	The proposal addresses an issue that is specific to a segment of the oil & gas industry and is a significant impediment	None

			to adoption of IFRSs for full cost companies. The proposals do not address ongoing post IFRSs adoption accounting.	
	Why broader than E&E in IFRS 6?	19	The proposals address a practical issue related to the development and production phases. These phases are not in the scope of IFRS6.	None
	Why would this exemption not apply to oil & gas companies that use successful efforts accounting?	34 56	Staff discussions with one respondent and other industry members have indicated that transitional issues for successful efforts companies are similar to many other industries. Paragraph BC8 of the exposure draft explained why the proposals would not apply to entities using successful efforts.	None
5. Full cost terminology	Full cost is not a defined term in IFRS. In some jurisdictions similar accounting may be followed but without using the terminology “full cost”. It would be better to describe the accounting rather than use the term	59 89	The term “full cost” is broadly recognized in the industry. The term is only used once in the proposed amendment to IFRS 1. To ensure that the exemption could be applied by entities that apply similar accounting, whatever the terminology, the description of full cost currently in a footnote could be included in paragraph 19A instead of the term “full cost”. The Basis should be similarly amended.	19A <u>Under some national GAAPs exploration and development costs for properties in development or production are accounted for in cost centres that include all properties in a large geographical area. (This is often referred to as full cost accounting.)</u> <u>A first time adopter using such accounting under previous GAAP</u> may elect…..

6. Impracticality	Exemption should be limited to circumstances where it is impractical to meet the existing requirements in IFRS 1	10 19	None of the existing IFRS 1 exemptions have a requirement to demonstrate the impracticality of applying IFRSs. There seems to be no reason to single out this exemption in this respect.	None
7. Allocation methodology	Volumes or values should be attributable to the same reserve categories for all assets to which the allocation applies Should relate to publicly disclosed reserve volumes or values Guidance should be provided on how different reserves categories should be weighted Should require "basis that gives the most appropriate allocation of cost" and state that this is generally value	10 10 17 59	The intent of paragraph 19A(b) was to set the high level parameters for the allocation methodology and to provide management the ability to determine the details of the allocation methodology that would be most appropriate for each existing cost centre. The suggestion that the allocation should relate to publicly disclosed reserves volumes or values would require a definition of "publicly disclosed" as some companies disclose more information about reserves on their website or elsewhere than they do in their annual report or regulatory filings. In any situation where there is a choice of allocation methodology, the choice made should be that which results in the most appropriate allocation, taking into account costs and benefits. It should not be necessary to state this. Staff does not recommend providing more detailed guidance on the allocation methodology.	None

8. Impairment requirement	Should first assess if there are indicators of impairment in accordance with IFRS 6 and IAS 36 – if require full impairment test for each asset then the benefits of the exemption would be largely negated.	85	IFRS 6 and IAS 36 allow for impairment tests to be at a CGU (or higher) level. The indicators of impairment in IFRS6 and IAS 36 would not meet the objective of providing assurance that the asset carrying amount is not impaired – that can only be done by considering the carrying amounts.	None
	Specify that any impairment on initial adoption is charged to retained earnings.	34	IFRS 1 requires all adjustments on initial adoption to be charged/credited to opening retained earnings.	None
9. Decommissioning	Adjustment should be to the asset rather than opening retained earnings	34	Respondent's letter does not provide additional reasons to those previously discussed by the Board	None
	Paragraph 25 EA (on decommissioning costs) should apply to all companies	60	This would be outside the scope of the proposed amendments to IFRS1.	None
	Paragraph 25 EA should also apply to assets in the exploration phase	89	Staff agrees that decommissioning obligations can be incurred during exploration. However since assets are in the exploration phase for a shorter period than they are in the development and production phases, and are not amortized,	None

			there are not the same difficulties in applying IFRS1. Also the costs of assets in the development and production phases will be based on an allocation per 19A(b) which significantly reduces the value of following the existing IFRS methodology for decommissioning costs on initial adoption of IFRSs.	
10. Disclosure	The proposed disclosure doesn't add anything additional to requirements in paragraphs 38 to 45 of IFRS 1	85	Paragraph 40 of IFRS 1 requires disclosure of "sufficient detail to enable users to understand the material adjustments to the balance sheet….." Paragraph 40 would only require disclosure of the fact that the proposed exemption had been used if the allocation resulted in a material adjustment (which would only occur if there is an impairment). It also might not be interpreted as requiring disclosure of the basis of allocation. Staff recommends retaining the disclosure for greater certainty.	None
	Disclose fact that deemed cost includes amounts that would not be capitalized under IAS 16, and the types of costs, until not material	17 34	The disclosure is likely to be boilerplate. The entity will not know the amount of costs included in the carrying amount that would not have been capitalized under IAS 16. There is no similar ongoing requirement where a company has used fair value as	None

			deemed cost.	
	Disclose reserve volumes/values used as basis of allocation and the resulting carrying amounts (deemed costs)	10	This would require disclosure at an asset level. For a larger firm there could be a significant number of oil & gas assets. IFRS does not require disclosure of the carrying amounts of individual assets.	None
	IAS 36 disclosures are not required by the ED proposals. They should either be explicitly required or disclosure should be required of how the recoverability of the assets at the date of transition was determined.	15 90	Paragraph 39 of IFRS 1 requires the disclosures in IAS 36 to be made if an entity recognizes an impairment loss for the first time in preparing its opening IFRS balance sheet.	None
11. Transition	Align transition adjustment (i.e. any asset impairment) with transition for decommissioning costs in BC7 – or discuss why impairment charge goes to income	17	Paragraph 11 of IFRS1 would result in any impairment at the date of transition being recorded in opening retained earnings – this is consistent with the requirement in 25EA for decommissioning costs.	None
12. Implementation guidance	IG 8 and 9 refer to deemed cost and should be amended to reflect these proposals	85	Agreed	See Appendix A

13. Basis of Application	Explain why relief needed now but not for companies that previously adopted IFRSs	10	The Basis provides an explanation of why the Board is making the changes to IFRS 1, including the circumstances facing full cost companies in countries adopting IFRSs in the coming years. The difference in circumstances relative to companies that previously adopted IFRSs is not relevant to the Board's decisions.	None
	Explain why the benefit of relief is greater than the resulting lack of comparability	17	BC 26 in IFRS 1 discusses costs and benefits in the context of IFRS1 and applies equally to these proposed amendments. BC 10 of IFRS 1 states "it is more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date: achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective". The reasons why the benefit of each of the existing exemptions is greater than the resulting lack of comparability is not included in the Basis.	None
	BC3 should refer to a principle (e.g. BC 26 of IFRS 1)	17	BC 26 is a principle that applies to all of IFRS1 – and therefore already covers these proposed amendments	None

	Rationale should be clearly stated to help in addressing future requests	59	Rationale is provided in BC 3 and BC 4 as well as the overall rationale for IFRS 1 in the existing standard and Basis.	None