



Energy Insights:  
International Financial Reporting Standards

# Easing the transition\*

New exemptions under IFRS 1  
for full cost companies

\*connectedthinking

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## Background

In July 2009, the IASB issued Additional Exemptions for First-time Adopters—*Amendments to IFRS 1* (the “Amendments”) which provides specific guidance to companies transitioning to IFRS for the first time. For oil and gas companies that currently apply the full cost method of accounting the new guidance helps to ease the potential transition to IFRS.

Historically, two accounting models for upstream oil and gas activities have existed under US GAAP—the full cost and successful efforts methods. The key difference between the two is the unit of account. The full cost method of accounting results in the aggregation and evaluation of project costs at a higher level than under the successful efforts method.

While there is diversity in the detailed application of each method, our experience in Europe and elsewhere has shown that successful efforts companies have not experienced significant transition issues with respect to their upstream accounting policies as the unit of account under the successful efforts method is generally consistent with IFRS. On the other hand, the unit of account used under the full cost accounting method for upstream production assets is not supported by current IFRS and therefore full retrospective restatement as envisioned under IFRS 1—*First-time Adoption of International Financial Reporting Standards* (“IFRS 1”) would be difficult and costly.

Prior to the Amendments, this situation was not addressed by the IASB for two principal reasons. One, the IASB has historically preferred to limit the amount of industry specific guidance being promulgated. Two, most oil and gas companies outside of North America followed a form of the successful efforts method of accounting.

With the upcoming conversion of Canadian oil and gas companies to IFRS, the issue gained more attention because many Canadian upstream companies follow the full cost accounting model. With Canada’s approaching conversion to IFRS effective in 2011, this was an urgent transition issue for such companies.

The key area of concern (prior to the Amendments) was the recognition and measurement of oil and gas assets on the opening IFRS balance sheet at transition date<sup>1</sup>. Applying IFRS 1 would have required full cost companies to retrospectively restate historical full cost pools and allocate values to appropriate units of accounts under IFRS and to retrospectively restate depreciation, depletion and amortization expense.

Clearly, changing the unit of account and retrospectively restating would give rise to significant difficulties in obtaining the necessary historical data. In addition, companies would incur significant costs from generating the necessary information for the retrospective allocation of the full cost pool.

<sup>1</sup> Transition date - is the beginning of the earliest period for which an entity presents full comparative information under IFRSs in its first IFRS Financial Statements.

## The Amendments: a closer look

Recognizing these unique issues faced by full cost companies adopting IFRS and applying the retrospective provisions of transitioning to IFRS, the IASB issued the Amendments to address the measurement of exploration and evaluation (“E&E”), development and production assets upon transition for companies using full cost accounting.

The new guidance states:

- *“A first-time adopter using such 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 respectively and, if necessary, reduce the amount determined in accordance with (a) or (b) above.”*

### Exploration and Evaluation Assets (unproved properties)

As a result of the provision at (a) above, upon transition, a full cost company will now have the option to measure its E&E assets at the amounts determined under the company’s previous GAAP (e.g. full cost for US GAAP) in its opening IFRS balance sheet or to move to the successful efforts method.

PwC expects that most full cost companies transitioning to IFRS will choose to use the exemption included in the Amendments. Similar to IFRS 6 which provided relief for full cost companies to continue to aggregate costs in large country wide cost centers, the Amendments allow such practice to continue during the E&E phase.

## Development and Production Assets (proved properties)

The Amendments also allow assets in the development and production phase to be measured initially at the amounts previously determined for the cost center under the company's previous GAAP (e.g. US GAAP) but requires that such assets be allocated to a level that complies with the conceptual framework. For a full cost entity transitioning to IFRS, this will likely be a much lower level.

The Amendments therefore allow the total cost of the cost center (full cost pool) to be allocated at transition date to the underlying assets (e.g. fields or wells) pro rata using reserve volumes or reserve values as of the transition date.

PwC expects that the allocation of the full cost pool to underlying assets will be a significant focus for management as the transition to IFRS occurs. This process will require significant judgment and estimates and will likely involve the use of experts in the determination of reserve volumes and/or reserve values. The judgment and rationale applied by management will also need to be disclosed in the company's financial statements prepared under IFRS. Overall, the allocation of cost to the underlying assets in the company's opening balance sheet will be an area that may be time-consuming and require significant input from management.

## Impairment

The prior GAAP full cost pool may include amounts that would not have been capitalized under IFRS, such as unsuccessful exploration costs (dry hole costs), overhead costs and other costs that were incurred before an entity obtained the legal right to explore a particular area. Therefore, the cost allocated to the underlying individual assets (fields) may include amounts that will not be recoverable. As a result, the Amendments require both E&E assets and development and producing assets be tested for impairment in compliance with IFRS 6 and IAS 36—Impairment of Assets respectively, at the transition date.

## Other Amendments

As a result of the exemption for full cost companies' cost pools, the IASB has also revised its transition provisions related oil and gas decommissioning and restoration liabilities. The guidance requires that full cost companies that apply the cost pool allocation exemption measure the related liability for oil and gas assets in the development or production phase at the date of transition under IAS 37—Provisions, Contingent Liabilities and Contingent Assets and recognize 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.

In addition, the Amendments include a clarification that if a first-time adopter made the same determination of whether an arrangement contained a lease in accordance with previous GAAP as that required by IFRIC 4 but at a date other than that required by IFRIC 4, the first-time adopter need not reassess that determination when it adopts IFRS.

## Path Forward

While the guidance above does provide an exemption with substantial relief to full cost companies, specific IT and data requirement challenges remain related to the transition.

As companies prepare to upgrade existing IT systems or implement new ones, they should carefully evaluate whether these systems can handle the increased amount of record keeping for oil and gas assets in cases specifically where companies previously used the full cost method of accounting. Identifying potential data gaps early will allow companies to design IT systems that deliver the necessary information efficiently.

Consideration should also be given to potentially increased disclosures under IFRS and dual-reporting requirements. Companies may need to prepare financial information under both IFRS and US GAAP during the transition period or after their non-US subsidiaries have begun reporting under IFRS. Robust disclosures will be needed as companies explain their initial allocation methodology of their full cost pools between E&E assets and producing properties.

By staying focused on aspects of IFRS adoption that have a longer lead time, including the effects these alternative paths could have on business, accounting, tax, investor, control, systems and work-force related issues, companies can stay ahead of the game and effectively plan for IFRS.

## About the author



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Steve is an assurance partner with over 20 years of experience serving international clients. Steve is one of the firm's lead partners in IFRS conversions for the Energy sector. He is a frequent speaker to clients and targets on the current developments in IFRS and key issues faced by U.S. companies transitioning to IFRS. He has more than a decade of experience in practicing in international accounting standards as a result of two international assignments in PwC locations in Europe and Asia. Steve's experience includes a secondment in Milan, Italy. Later, Steve spent 3 years in Moscow, Russia as a partner working with one of the world's largest companies reporting under International Financial Reporting Standards (IFRS). Upon his return from Moscow, Steve has been focused on helping major US companies in their evaluation of the implications of converting from US GAAP to IFRS. He serves on the PricewaterhouseCoopers Global Energy IFRS Experts Committee.

## About PricewaterhouseCoopers

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