Applying IFRS in the Oil & Gas Sector

Potential implications of the amendments to IFRS 11 Joint Arrangements

November 2014
What you need to know

- The amendment to IFRS 11 means entities will now need to apply the principles of business combinations accounting when acquiring an interest in a joint operation that constitutes a business.

- The changes will increase the focus on the interpretation and application of the definition of a business.

- For some entities, this will be a significant change to current practice that:
  - Will require greater time, cost and effort
  - May lead to significant changes to balance sheets and profit or loss profiles

- There is still a significant number of areas where the accounting requirements remain unclear and, without clarification, diversity may continue. These include:
  - Contingent consideration
  - Step acquisitions - moving from joint control to control
  - Contributing a business to a joint operation
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Overview

In May 2011, the IASB issued a new standard, IFRS 11 Joint Arrangements, which became effective from 1 January 2013. Two of the primary changes introduced by IFRS 11 were, as follows:

- There are now only two types of joint arrangements — joint ventures and joint operations — with the latter likely to be more common in the oil and gas sector
- Proportionate consolidation is no longer permitted for arrangements classified as joint ventures; instead, equity accounting has to be applied

IFRS 11 provides guidance on most of the accounting for joint operations, but there are certain issues that it does not address. One such issue is how a joint operator (one of the parties with joint control over a joint operation) should account for the acquisition of an interest in a joint operation that constitutes a business. The predecessor to IFRS 11, IAS 31 Interests in Joint Ventures, was also silent on this issue, leading to diversity in practice.

Some oil and gas entities applied full business combinations accounting to acquisitions of interests in joint operations, as they considered this approach to be most relevant. Others applied the relative fair value approach, as they felt the business combination principles only applied where control was obtained, not joint control. A small group only applied business combinations accounting to the issues that were not covered in other standards. There were concerns that, without clarification, such diversity could continue under IFRS 11. The matter was referred to the IFRS Interpretations Committee (the Interpretations Committee) and then to the IASB. As a result, an amendment to IFRS 11 entitled Amendments to IFRS 11 – Accounting for Acquisitions of Interests in Joint Operations, was issued by the IASB in May 2014.

The amendment states that, where a joint operator acquires an interest in a joint operation in which the activity of the joint operation constitutes a business, it must apply all of the principles for business combinations accounting, as set out in IFRS 3 Business Combinations and other standards. In addition, the joint operator must disclose the information required by IFRS 3 and other IFRSs for business combinations.

For many oil and gas entities, the amendment will represent a significant change to current practice. In this edition of Applying IFRS, we summarise the changes and explore some of the potential implications for oil and gas entities. We also highlight some areas where uncertainty remains and which, if unaddressed, could contribute to ongoing diversity.
1. Summary of the amendment

The amendment to IFRS 11 clarifies that, when acquiring an interest in a joint operation where the activity of the joint operation constitutes a business, all of the principles for business combinations accounting in IFRS 3 and other IFRSs, that do not conflict with the requirements of IFRS 11, must be applied. The requirements apply to the acquisition of both the initial interest and additional interests in a joint operation. While not specifically stated, we interpret this to mean that the amendment applies to subsequent acquisitions of interests where joint control is maintained. The amendment also makes it clear that any previously held interest in the joint operation would not be remeasured if the joint operator acquires an additional interest while retaining joint control.

In addition, the joint operator must disclose the information required by IFRS 3 and other IFRSs for business combinations.

The amendment states that the principles of business combinations accounting that do not conflict with the requirements of IFRS 11 include, but are not limited to:

- Measuring identifiable assets acquired and liabilities assumed at their acquisition-date fair values (unless an exception is given in IFRS 3 or other standards)
- Recognising acquisition-related costs as expenses in the period in which the costs are incurred and the services are received (unless they represent equity or debt-raising costs)
- Recognising deferred tax assets and liabilities that arise from the initial recognition of assets and liabilities (excluding the initial recognition of goodwill)
- Recognising the excess of the consideration transferred over the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed (if any), as goodwill
- For cash generating units to which goodwill has been allocated, testing for impairment at least annually, and when there is an indication that the unit may be impaired (as required by IAS 36 Impairment of Assets for goodwill acquired in a business combination)

2. Effective date and transition

The amendment will apply prospectively to those acquisitions in scope that occur on or after the effective date of 1 January 2016, so comparatives do not need to be restated (i.e., retrospective application is prohibited). This transition approach was recommended to avoid the use of hindsight, which an entity would have to apply if it had to retrospectively determine the acquisition-date fair values of assets and liabilities that had been acquired prior to the effective date.
2.1 Accounting for similar transactions prior to the effective date

Given the diversity in practice that existed previously and ultimately resulted in the IASB issuing this amendment to IFRS 11, a common question is how such transactions should be accounted for prior to the effective date?

There are several acceptable views, including:

• Early adoption of the amendment, to be consistent with the IASB's final position
• Continued application of an existing accounting policy - an entity that had previously undertaken such a transaction and applied a principle that differed from that in the amendment could continue to apply its previous policy to a current acquisition in a joint operation
• Application of a policy choice - an entity that has never undertaken such a transaction before would have a policy choice, given the amendment only applies prospectively and diverse treatments have been accepted to date

3. Scope

3.1 Overview

The amendment applies to the acquisition of an interest:

• In an existing joint operation that is a business
  Or
• On the formation of a joint operation when an existing business is contributed by one of the parties that participates in the joint operation

It would not apply to the formation of a joint operation where it coincides with the formation of a business, e.g., when an entity forms a joint operation, and the assets (and liabilities, if relevant) being contributed did not represent a business previously, but when combined in the joint operation would now create a business (from the perspective of the joint operation).

3.2 Contribution of a business to a joint operation – greater clarity required

When acquiring an interest in a joint operation, or on formation of a joint operation, at least one party may contribute a pre-existing business. For example, if an entity owns 100% of a producing gas field, which is considered to meet the definition of a business under IFRS 3, and another party acquires an interest in the producing field, the entity contributing the gas field loses control of the business and replaces it with joint control over the same business (and possibly additional assets or businesses). While the amendment to IFRS 11 makes it clear how an acquiring entity should account for its acquisition of an interest in a joint operation, it is less clear how the party losing control over the business should account for its contribution.
Unrelated to the recent amendment to IFRS 11, the standard could be interpreted as requiring partial gain/loss recognition on the loss of control of the business. IFRS 11 requires an entity that sells or contributes an asset to a joint operation to recognise any gain/loss only to the extent of the other parties’ interests in the joint operation. However, recently issued amendments to IFRS 10 Consolidated Financial Statements, and IAS 28 Investments in Associates and Joint Ventures, appear to contradict this interpretation, specifically, whether the term ‘asset’, as currently used with respect to this requirement, includes the concept of a business.

The recent changes to IFRS 10 and IAS 28 refer to contributions of a business to an associate or joint venture (i.e., the other type of joint arrangement under IFRS 11). While these amendments deal with joint ventures but not joint operations, some question whether the amendment could be used by analogy to determine how to account for similar transactions involving joint operations.

Prior to the amendments to IFRS 10 and IAS 28, some standards and interpretations appeared to conflict on the accounting for contributions of businesses to jointly controlled entities (JCEs) (which were a type of joint venture under IAS 31). Specifically, the conflict related to whether an entity, upon losing control of a business, should remeasure its retained interest in the business to fair value and recognise the full gain/loss on the transaction, or whether the retained interest should not be remeasured to fair value and only a partial gain/loss be recognised.

The amendment to IAS 28 makes it clear that if an entity contributes a business to a joint venture or an associate, regardless of whether it is housed in a subsidiary or not, it must recognise any gain/loss on the transaction in full, i.e., the entity must remeasure any retained interest in that business to fair value at the date it loses control. The amendment to IFRS 10 states that remeasurement of a retained interest in a subsidiary on sale or contribution to a joint venture or associate will only be required when that subsidiary constitutes a business.

While the amendments to IAS 28 remove the uncertainty with respect to contributions to joint ventures, the question still remains as to whether they will be applied by analogy to joint operations, which could affect how entities account for contributions of businesses to joint operations. The question also arises whether the accounting should differ between the consolidated financial statements and the separate financial statements (if applicable).
How we see it

To date, informal discussions on this issue within the oil and gas sector, the extractive industries at large, and more broadly, have already offered differing views. Some believe it is clear that similar principles to those proposed for contributions of businesses to joint ventures should apply by analogy to contributions of businesses to joint operations, i.e., full gain/loss recognition, as the nature of the investment has changed.

However, others believe partial gain/loss recognition is more appropriate, particularly at the consolidated level. This is because the entity is simply reducing its rights to, and obligations for, the same assets and liabilities. Therefore, it would be inappropriate to recognise a full gain/loss on this transaction.

Given the diversity of views, we believe it is important for the IASB to provide additional guidance on this matter, preferably via a further amendment to IFRS 11.

4. The challenges

While the amendment may seem relatively straightforward, it presents a number of challenges for entities that have not previously applied a business combinations approach, as it will require a significant change in accounting practices. We discuss some of the challenges for oil and gas entities in this section. There are also related considerations where the principles are not entirely clear and we explore these in subsequent sections below.

4.1 Business versus asset

A key judgement that is relevant to all business combinations, and in determining which arrangements will be impacted by the amendment, is whether the activities of the joint operation, or the set of activities and assets contributed to the joint operation on its formation, represent a business as defined by IFRS 3.

On 1 January 2009, the revised version of IFRS 3 became effective, introducing a new definition of a business, as follows:

- An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.\(^3\)

IFRS 3 explains that a business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set of activities to qualify as a business.\(^4\) An output is defined as the result of inputs and processes applied to those inputs that provide, or have the ability to provide, a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.\(^5\)

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\(^3\) IFRS 3 Appendix A \\
\(^4\) IFRS 3.BC7 \\
\(^5\) IFRS 3.BC7(c)
How we see it

In our view, while the new definition of a business in IFRS 3 was considered to be merely an improvement on the previous one, it did seem to broaden the previous definition, with the result that more transactions were likely to qualify as businesses. However, despite the revised version of IFRS 3 having been applied for more than three years, the assessment of whether a set of activities and assets represents a business is still highly judgemental in the oil and gas sector and has led to diversity in interpretation and application.

The amendment to IFRS 11 increases the scope of transactions that would need to be assessed to determine whether they represent the acquisition of a business or an asset.

The IASB is currently undertaking its post-implementation review of IFRS 3. One of the key issues it is addressing is the definition of a business. The IASB has sought comment as to the practical implementation, auditing or enforcement challenges stakeholders may have faced when applying this definition.

Given this and the fact that applying this definition in practice has proven to be subject to significant judgement, oil and gas entities will need to monitor these developments to determine whether there will be any changes/clarifications that may impact the way in which they have applied the definition of a business.

4.2 Increased time, cost and effort

Determining the fair value for the identifiable assets acquired and liabilities assumed is required for both a relative fair value approach and a business combinations approach. However, this may require greater time, cost and effort for the business combinations approach. This is because in applying the relative fair value approach, many entities have historically determined the fair value of all assets and liabilities (excluding exploration or production rights/assets), recognised those amounts as part of the acquisition entries, and then allocated any residual to the exploration and production rights/assets. They have generally tended not to dedicate a great deal of effort to separately valuing the exploration and production rights/assets, or to identifying and valuing other intangible assets, such as value beyond proven and probable reserves and/or acquired exploration potential.

For entities that have not previously done so, applying a business combinations approach will require all assets to be fair valued, including exploration and production rights/assets and the other identifiable intangible assets. Valuing such assets is more complicated and therefore more time-consuming and costly.

In addition, as the requirements are to be applied to each tranche purchased, further fair value exercises will be required if, and when, the entity increases its interest in the joint operation at a later date.
4.3 **Balance sheet and profit or loss profiles may change**

Oil and gas entities that have not previously applied the business combinations approach, may experience changes to their balance sheet and/or profit or loss profiles because:

- Assets and liabilities will initially be recognised at different amounts compared with a relative fair value approach
- Deferred tax balances may need to be recognised (where relevant) as the initial recognition exemption will not be available
- Transaction costs will have to be expensed rather than capitalised
- Goodwill may be recognised

4.4 **Increased complexity of record-keeping**

In some instances, the joint arrangement operator maintains the ledgers of each of the parties to the joint arrangement. This process would become more complex if business combinations accounting now has to be applied, especially if the parties acquire their interests at different times.

5. **Other areas where further clarity is required**

The amendment requires that the principles of business combinations accounting in IFRS 3 and other IFRSs that do not conflict with IFRS 11 are to be applied. It provides a non-exhaustive list of five principles that are not considered to conflict with IFRS 11. This still potentially raises the question about the various other business combination principles and which of them are considered not to conflict with IFRS 11. Below, we explore how this lack of clarity may contribute to divergent interpretations.

In some instances, it will be obvious which principles do not apply. For example, an entity would not apply the requirements relating to the recognition of a non-controlling interest. It would only apply the business combinations principles to the interest it acquired and not the remaining interest(s) in the joint arrangement. This is because it does not control these interests. However, in other instances, it is not clear which other business combinations principles apply, such as accounting for bargain purchases; accounting for the consideration transferred; and accounting for step acquisitions.

5.1 **Bargain purchases**

While one of the five principles listed in the amendment discusses the recognition of goodwill, it does not make any reference to a gain on a bargain purchase and how it should be accounted for. Therefore, it is unclear whether similar principles in IFRS 3 or another method of accounting apply. In this case, we would expect similar principles to apply.
5.2 Consideration transferred
The amendment does not discuss how contingent consideration (if any) should be treated in terms of consideration transferred, or what should happen when there is no consideration.

Contingent consideration
IFRS 3 is clear as to how contingent consideration in a business combination should be treated. However, in respect of the acquisition of an interest in a joint operation that is a business, it is not clear whether the amendment would require the IFRS 3 contingent consideration principles, or some other principles, to be applied. Further clarification may be needed, particularly if the view is that the IFRS 3 principles do not apply.

Clarification is important because:
• Arrangements involving the acquisition of an interest in a joint operation can take many different forms and may involve a range of variable payments, e.g., certain types of royalty arrangements, some of which may be considered contingent consideration
• There is diversity in the accounting for contingent consideration relating to acquisitions that are outside the scope of IFRS 3, e.g., acquisitions of property, plant and equipment (PP&E). Specifically, there are differences in views about when such contingent arrangements should be initially recognised as a liability, i.e., at the date the asset is acquired or at a later date. There are also differences in view about where any subsequent movements in such a contingent consideration liability should be recognised, i.e., as either an adjustment to the asset acquired or in profit or loss

Given the diversity in practice, the issue of contingent consideration in the acquisition of PP&E has been raised with the Interpretations Committee, but has been put on hold until the IASB has completed the leases project. However, the Interpretations Committee has tentatively proposed an accounting treatment that would differ from that currently applied to contingent consideration in a business combination.

No consideration
The amendment also appears to be silent on the accounting for the acquisition of an interest in a joint operation for which no consideration has been transferred. This could occur where an initial assessment of the contractual arrangements did not result in joint control, as defined in IFRS 11. Therefore, the arrangement was not in the scope of IFRS 11. An example of this could be an arrangement where there are three parties, each with a one-third interest in the joint operation, but where the decision-making process only requires any two parties to agree. As there are multiple combinations under which a decision can be reached, joint control, as defined in IFRS 11, is not considered to exist.
However, a subsequent change in facts and circumstances, such as one of the parties defaulting on its cash calls, could change the assessment such that joint control is considered to exist. This would bring the arrangement within the scope of IFRS 11. Following on from the example above, where one of the parties is in default in respect of its cash calls under the contractual arrangement, that party’s interest is automatically transferred equally to the other two parties, thereby giving them equal ownership interests of 50% each. However, the two parties would not assume the defaulting party’s unpaid cash call. As both of the remaining parties will need to agree to pass a decision, joint control will now be considered to exist.

In this instance, the parties now have an interest in a joint operation, but no consideration has been transferred.

**How we see it**

While the IASB has provided greater clarity as to five of the principles that are to be applied, we believe there remains some risk of continued uncertainty in relation to certain other principles. This may result in diversity in practice.

5.3 Accounting for step acquisitions

The third area of uncertainty relates to those transactions where an entity moves from joint control to control.

From time to time, an oil and gas entity may acquire an initial interest and/or a subsequent interest in a joint operation, e.g., via a farm-in arrangement (refer section 6), while continuing to maintain joint control. It may then acquire a further interest which moves it from joint control to control. For example, the entity may have farmed in for an original 50% interest in a joint operation and then undertakes a further farm-in to acquire the remaining 50% such that it now owns 100% of the assets and liabilities of the arrangement. The question is, how should this be accounted for?

It could be argued that this situation is somewhat similar to a business combination achieved in stages (as referred to in IFRS 3, or more commonly referred to as step acquisitions). This is where an acquirer obtains control of an acquiree in which it held an equity interest immediately before the date on which it obtained control (i.e., the acquisition date). In this situation, the acquirer is required to remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in full in profit or loss. This would be on the basis that the nature of the investment has changed as the entity now has control over the business. Therefore, full gain/loss recognition is appropriate.

Alternatively, it could be argued that the transaction simply involves the entity acquiring an additional interest in a number of assets and/or liabilities in which it already had a direct interest (which did not represent an equity interest) and that the nature of the interest has not changed. Therefore, only partial gain/loss recognition is required.

This question was raised by a constituent in the initial deliberations by the Interpretations Committee. While the Interpretations Committee staff acknowledged that it was a valid issue, they believed it went beyond the scope of the guidance being developed on these acquisitions. This was because it was considered not to be related to the acquisition of an interest in a joint operation, but to the loss of joint control or the disposal of an interest in a joint operation. The staff did, however, indicate that it should be considered separately at some point in the future.
How we see it
There is significant diversity in views about whether the requirements in IFRS 3 for business combinations achieved in stages should apply to transactions where a joint operator goes from joint control of a joint operation to control.

While we understand that the Interpretations Committee saw this issue as outside the scope of the amendment, we believe it is critical that all issues relating to transactions involving joint operations are addressed. Therefore, we strongly recommend that the IASB address this issue through another avenue, on a timely basis, to help avoid further diversity.

6. Impact on farm-in arrangements
Farm-in arrangements are common in the oil and gas sector. A farm-in involves the transfer of part of an exploration or production interest as consideration for an agreement by the transferee (farmee) to meet certain expenditure that would otherwise have to be undertaken by the owner (farmor). A farm-in is characterised by the farmor giving up future economic benefits, in the form of reserves, in exchange for a reduction in future funding obligations, which are instead, met by the farmee.

Depending on how the farm-in is structured, these arrangements can result in the acquisition of an interest in a joint arrangement, and may potentially be classified as joint operations. Given this, the effect of the IFRS 11 amendment will need to be considered. There are many issues to consider, some of which we discuss below.

6.1 Business versus asset
Farm-in transactions generally occur in the exploration or development phase of an oil and gas project. As discussed above, there are divergent views about how the definition of a business should be interpreted and applied to the acquisition of an interest in a joint operation in these phases. As such, this will add to the complexity of accounting for farm-ins.

6.2 Determining the date at which to recognise the transaction
Farm-in transactions can take many different forms. Some involve the farmee obtaining its interest in the project up front, whereas in others, the farmee only receives its interest once it has completed the required activities.

The farmee will need to assess if, and when, joint control commences, as this will impact:

- Whether the arrangement is in the scope of IFRS 11 and is affected by the amendment to IFRS 11
- When the farmee is considered to have acquired its interest, as this will be the date at which the business combinations accounting principles will need to be applied, i.e., the fair value of the assets and liabilities acquired at this date will need to be determined

When it comes to farm-in arrangements, an entity will need to determine whether and when it is able to demonstrate that it is operating under joint control. This may or may not coincide with the point when the farmee is actually granted its percentage share in the arrangement.

Also, for arrangements where the farmee is only considered to acquire its interest in the joint operation once all activities are completed and where joint control will only exist from that date, it will need to decide how it will account for any expenditure incurred on the farmor’s behalf up to that date.
6.3 Determining consideration transferred

Farm-in arrangements can be structured in numerous ways, some requiring payment of a fixed monetary amount upfront and/or in the future. Others may be more flexible and state, for example, that capital expenditures over the next five years will be paid for by the farmee regardless of what those amounts may be, or that an additional payment may be contingent on a particular outcome, e.g., the success or failure of certain exploration activities. Consequently, determining the exact timing and amount of the future commitments may be complex.

There is some diversity in practice in the accounting for these types of arrangements. In some cases, the view is that the liability of the farmee to pay the farmer’s share of the future capital expenditure commitments meets the definition of a financial liability under IAS 32 *Financial Instruments: Presentation*, and should be accounted for in accordance with IAS 39 *Financial Instruments – Recognition and Measurement*. There is also some debate about when this liability should be recognised. Some argue that the liability for the future farm-in commitments should be recognised upfront at the start of the farm-in, whereas others argue it should be recognised at a later date.

In scenarios where the timing and amount of the future payments are uncertain, some believe that such commitments represent a provision that should be recognised under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. However, there are divergent views about when such a provision should be recognised, i.e., what the obligating event is, leading to diversity in the accounting for such commitments.

Having said that, while there may be differences in the timing of recognition of the future farm-in commitments, there is generally consistency in how they are then treated. That is, most farmees apply a cost-based approach when accounting for the expenditures under a farm-in arrangement and generally account for them in the same way as they would for directly incurred Exploration and Evaluation (E&E) or development expenditure. For example, if the farmee expenses directly-incurred E&E expenditures when it recognises the farmer’s share of such E&E expenditures, it will also expense them. Whereas, if the farmee capitalises directly incurred E&E expenditures, and/or directly incurred development costs, when it recognises the farmer’s share of such costs, it will also capitalise those costs.

As discussed above, it is not clear how contingent consideration associated with the acquisition of an interest in a joint operation that is a business should be accounted for. If, for example, the IFRS 3 principles on contingent consideration were applied, this would fundamentally change the accounting for farm-ins that involve future funding commitments that are considered to be contingent consideration.

For example, for those entities that had not previously treated the future farm-in costs as contingent consideration, and assuming the same principles in IFRS 3 would apply, the changes would:

- Introduce additional complexity to the farmee’s accounting, as it would now have to fair value the future commitments if they are considered to be contingent consideration (which may be complex, depending on the nature of the farm-in arrangement)
- Impact the calculation of any potential goodwill or bargain purchase to be initially recognised in relation to the transaction
6.4 Increased time, cost and effort and changes to balance sheet and profit or loss profiles

It is currently common practice for an oil and gas entity to apply a cost-based approach to accounting for farm-ins and, therefore, not to apply business combinations accounting principles. For farm-ins in the scope of the amendment, having to apply these principles will increase the time, cost and effort required to complete the accounting and may have a significant impact on the balance sheet and profit or loss profiles.

Of particular relevance will be the potential impact on contingent consideration. IFRS 3 requires contingent consideration to be fair valued at initial acquisition, with any subsequent changes to be recognised in profit or loss. Given the nature of farm-in arrangements, the value of the future funding commitments could vary considerably. This would create future volatility in earnings for entities that previously capitalised these future farm-in commitments as part of their oil and gas assets.

Entities will need to understand what the impact will be as part of the process of assessing, and ultimately accounting for, future deals.

7. Final thoughts

The amendment to IFRS 11 is likely to have significant implications for some oil and gas entities. At the very least, additional steps will be required to analyse future acquisitions of interests in joint operations to determine whether they are in scope. For those that are in scope, the requirement to apply business combinations accounting will mean the accounting for the acquisition will become more complex and may lead to different balance sheet and profit or loss profiles. As there are many aspects of the accounting that are still somewhat unclear, it is difficult to fully assess what the actual impact will be. However, what is clear is that application of the amendment to IFRS 11 is anticipated to result in increased time, cost and effort to account for transactions.

How we see it

Given the regular occurrence of transactions involving joint operations in the oil and gas sector, all such entities are encouraged to take the time to fully understand the implications of the amendment and assess the potential impact on their businesses.

If there are particular concerns about the potential impact, or there are areas where uncertainty may exist, entities will need to develop their own views as to how this amendment should be interpreted and applied. This may require consultation with their professional accounting advisors or auditors.
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