VIEWPOINTS:
Applying IFRSs in the Oil and Gas Industry

ACCOUNTING FOR DECOMMISSIONING LIABILITIES ASSUMED IN A BUSINESS COMBINATION

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Background

Oil and gas entities often acquire projects directly or through the acquisition of shares of another oil and gas entity. Among other things, the acquisition of such projects may include the assumption of decommissioning, restoration and similar liabilities (to be referred to as "decommissioning liabilities" in this document).

If the acquired project constitutes a business and the acquirer obtains control of that business, the transaction is considered a business combination within the scope of IFRS 3 *Business Combinations*.[1] Under IFRS 3, a business combination is accounted for using the "acquisition method", which requires assets acquired and liabilities (including provisions for decommissioning liabilities) assumed to be measured at their acquisition date fair values, subject to certain exceptions.[2] IFRS 13 *Fair Value Measurement* provides guidance on how to measure fair value.

In accordance with IFRS 3, in general, an acquirer subsequently measures and accounts for assets acquired and liabilities assumed in accordance with other applicable IFRSs for those items.[3] In the case of assumed provisions for decommissioning liabilities, such provisions are subsequently measured in accordance with IAS 37

1 The Oil and Gas Industry Task Force on IFRSs ***Viewpoint — Asset Acquisition versus Business Combination*** discusses some of the factors an acquirer should consider in making the determination whether the acquired project meets the definition of a business. IFRS 3 applies to a transaction or other event that meets the definition of a business combination except as outlined in IFRS 3.2.

2 Refer to IFRS 3.21–.31 and related guidance in Appendix B of IFRS 3 for recognition and measurement exceptions.

3 Refer to IFRS 3.54–.58 for specific guidance on subsequent measurement for certain assets and liabilities.

Oil and Gas Industry Task Force on IFRSs

Canada's move to International Financial Reporting Standards (IFRSs) creates 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 the CAPP, EPAC, CPA Canada or the organizations represented by the task force's members.

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Provisions, Contingent Liabilities and Contingent Assets. Under IAS 37, a provision is measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* provides more prescriptive guidance in accounting for certain changes to decommissioning liabilities.

A decommissioning liability measured at fair value in accordance with IFRS 13 can potentially differ materially from a best estimate amount calculated under IAS 37. Among other things, a decommissioning provision measured at fair value, under IFRS 3 and IFRS 13, is based on market participant assumptions and typically includes a profit element and an adjustment for credit risk (as part of non-performance risk). Under IAS 37, such a provision is measured at the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. This is considered to be more of an entity specific measurement than a market participant measurement. If, for example, an oil and gas entity plans to perform remediation work itself, it would measure such a provision at management's best estimate which, among other things, would exclude a profit element and be discounted at an appropriate rate.[4]

As a result of the measurement differences between IFRS 13 and IAS 37, different approaches to subsequently accounting for decommissioning liabilities assumed in a business combination exist in practice.[5]

Assumption of decommissioning liabilities in a business combination is not unique to the oil and gas industry; however, due to the prevalence and size of decommissioning liabilities in this industry, the measurement of such liabilities is typically a significant issue.

Issue

How to account for decommissioning liabilities assumed in a business combination?

Viewpoints

Decommissioning liabilities assumed in a business combination are measured at their acquisition-date fair value in accordance with IFRS 13 as required by IFRS 3.

Subsequent to initial measurement (i.e., Day 2) these provisions are to be measured using the principles in IAS 37, which may result in an adjustment to the initial measurement value — a Day 2 gain or loss.

4 In 2011, the IFRS Interpretations Committee noted that IAS 37 does not explicitly state whether or not own credit risk should be included in the discount rate. Based on deliberations, the IFRS Interpretations Committee chose not to issue authoritative guidance to clarify the requirements of IAS 37, necessitating the use of judgment in applying this standard.

5 In June 2014, the Canadian Accounting Standards Board's ('AcSB') IFRS Discussion Group discussed the accounting for asset retirement obligations assumed in a business combination or asset purchase. To listen to the audio recording of this discussion or to obtain the full written report, please visit the AcSB website or click **here**.

As there is no current prescriptive guidance on the accounting for such a Day 2 gain or loss, different approaches exist in practice, such as:

Approach A (Balance Sheet Approach)—Proponents of this approach view IFRIC 1 as a relevant source of guidance because IFRIC 1 discusses the accounting for changes in existing decommissioning liabilities. In general, changes in existing decommissioning liabilities related to IAS 16 *Property, Plant and Equipment* are added to or deducted from the cost of the related asset.[6]

Approach B (Income Statement Approach)—Proponents of this approach do not view IFRIC 1 as a particularly relevant source of guidance because IFRIC 1 only deals with measurement changes as a result of changes in the timing and/or amount of the outflow of economic resources by an entity. From this perspective, any Day 2 difference is recorded in profit and loss.

In the experience of the Oil and Gas Industry Task Force on IFRSs, Approach A is perceived to be more prevalent in practice.

In 2014, the International Accounting Standards Board (IASB) issued a *Request for Information—Post-implementation Review: IFRS 3 Business Combinations*. This document was intended to gather information from a broad range of constituents about their experience with implementing IFRS 3. In its review process, the staff of the IASB acknowledged the challenges of measuring provisions assumed in a business combination. As of December 2014, however, the staff had not included this issue on its list of significant items that the IASB should consider for follow-up.[7] A formal feedback statement from the IASB is expected in 2015.

Until the challenges outlined above are resolved, preparers are encouraged to exercise judgment in subsequently accounting for decommissioning liabilities assumed in a business combination. Oil and gas entities should consider consulting their professional advisors and auditors when undertaking such analysis.

6 Assumes property, plant and equipment are measured using the cost model. Different guidance applies to property, plant and equipment measured using the revaluation model.

7 Refer to the December 2014 IASB Agenda Paper 12B, Post-implementation review IFRS 3 *Business Combinations*—"Findings". To download a copy of this paper visit the IASB website or click **here**.

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