EFRAG
European Financial Reporting Advisory Group

The costs and benefits of implementing the Amendments to IFRS 1 *Additional Exemptions for First-time Adopters*

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of the amendments to IFRS 1 *Additional Exemptions for First-time Adopters* (the Amendments).

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. (The results of the consultations EFRAG has carried out seem to confirm this.) Therefore, as explained more fully in the main sections of the report, the approach EFRAG has adopted has been to carry out an initial assessment of the likely costs and benefits of implementing the revision in the EU, to consult on the results of that initial assessment, and to finalise the assessment in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB and IFRIC against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A summary of the Amendments

4 Generally when an entity prepares its first IFRS financial statements it applies IFRS in full in its opening IFRS statement of financial position when recognising and measuring assets and liabilities. However, IFRS 1 provides a limited number of exemptions and exceptions as a practical solution for certain implementation issues that arise on first-time adoption.

5 The Amendments comprise three separate amendments, each of which introduces further or amended exemptions to existing IFRS for first-time adopters.

Deemed cost for oil and gas assets

6 IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets* apply to the recognition and measurement of most assets under IFRS, including assets used in the development and production phases of oil and gas activities. IFRS 6 *Exploration and Evaluation of Mineral Resources* applies to the recognition and measurement of assets in the exploration and evaluation phases of oil and gas activities.

7 Certain entities with oil and gas activities are allowed under their local GAAP to recognise and measure assets using a different unit of account to that required under IFRS. These entities account for both exploration and development costs in large cost centres or geographical areas that might contain many oil and gas properties using a method often referred to as 'full cost accounting'. IAS 16 requires a smaller unit of account such as the individual property for oil and gas activities. As a result, the full cost method of accounting can include in the carrying amount of oil and gas assets unsuccessful exploration costs of prior periods that would have been expensed under IFRS.

8 Re-measuring oil and gas assets on first-time adoption in accordance with existing IFRS is difficult for some of these entities because either the information might not be available or the effort and associated costs to determine the opening IFRS statement of financial position might be very high.

9 The Amendments allow entities with oil and gas activities to transition to IFRS using carrying amounts for oil and gas assets determined under their previous GAAP. They further allow, for oil and gas assets used in the development and production phases, the entity to allocate the previous GAAP carrying amount of the cost centre on a pro rata basis to the underlying assets using either reserves quantities or values. The Amendments refer to this as measuring the assets at 'deemed cost'.

10 The Amendments ensure that the resulting asset amounts are not overstated by requiring them to be tested for impairment at the date of transition in accordance with IAS 36 *Impairment of Assets*.

Decommissioning, restoration and similar liabilities

11 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that an entity recognises a liability for the future costs to dismantle, remove and restore assets when it has an obligation to do so. IAS 16 requires the initial estimate of the amount of that liability to also be included as part of the cost of an item of property, plant and equipment. IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* sets out the requirements that apply on the subsequent re-measurement of the obligation because of changes in the estimated future cash flows needed to settle the obligation. It explains that, if the assets are being measured on a cost basis, the remeasurement of the obligation should be adjusted against the carrying amount of the asset.

12 Although IFRS 1 already includes an exemption for first-time adopters from IFRIC 1's requirements for changes in existing decommissioning, restoration and similar liabilities that occurred before the date of transition to IFRS, the deemed cost exemption described above creates further issues for first-time adopters that are not addressed by that existing exemption. The Amendments address these issues by requiring an entity that uses the deemed cost exemption to measure

decommissioning, restoration and similar liabilities as at the date of transition to IFRS in accordance with IAS 37 and recognise directly in retained earnings (rather than by adjusting the cost of the asset) any difference between that amount and the amount of the liability under the entity's previous GAAP.

Reassessment of lease determination

13 IFRIC 4 *Determining whether an Arrangement contains a Lease* specifies criteria for determining, at the inception of an arrangement, whether it contains a lease. It also specifies when an arrangement should be subsequently reassessed.

14 Under existing IFRS, a first-time adopter can either apply IFRIC 4 retrospectively (and carry out re-assessments as required by IFRIC 4 for the periods before transition) or can apply it to arrangements existing at the start of the earliest period for which comparative information is presented on the basis of facts and circumstances existing at the start of that period.

15 It has been brought to the IASB's attention that some jurisdictions have national requirements that have the same effect as IFRIC 4, including the same transitional provisions. However, if a first-time adopter in such a jurisdiction has applied those requirements from a different date to the date in the transitional provisions of IFRIC 4, existing IFRS would require the entity to reassess that accounting retrospectively on first-time adoption. The IASB believes this could result in additional costs with no obvious benefits.

16 The Amendments seek to address this issue by providing an optional exemption for a first-time adopter if the entity made the same determination of whether an arrangement contains a lease under its previous GAAP, provided that the application of their previous GAAP would be expected to produce a similar result as IFRIC 4.

Effective date

17 Entities are required to apply the Amendments for annual periods beginning on or after 1 January 2010. Earlier application is permitted but must be disclosed.

EFRAG's initial analysis of the costs and benefits of the amendments to IFRS 1

18 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users both in year one and in subsequent years from implementing the Amendments in the EU.

19 The tentative conclusions reached about additional costs for preparers were that:

(a) the deemed cost and decommissioning, restoration and similar liability amendments are likely to be cost neutral for the preparers affected both in year one and on an ongoing basis; an

(b) the lease determination amendment is likely to result in year one cost savings for the preparers affected and no change in their ongoing costs.

Furthermore, as entities have a choice as to whether they implement the Amendments, EFRAG believed it could be assumed that an entity will implement one or more of the amendments set out only if it believes the benefits to it of implementation are likely to exceed the implementation costs involved.

20 EFRAG also tentatively concluded that the Amendments will involve users in additional but insignificant year one costs and ongoing costs. However, the Amendments will make it possible for more entities to adopt IFRS, and EFRAG's initial assessment was that will result in a significant reduction in costs for users. As a result, EFRAG's overall initial assessment was that the Amendments would result in reduction in costs for users.

21 As a result, EFRAG's overall tentative conclusion was that the benefits to be derived from implementing the Amendments in the EU are likely to exceed the costs involved.

22 EFRAG published its initial assessment and supporting analysis on 7 September 2009 and invited comment on the material by 7 October 2009. The results of this consultation can be summarised as follows:

(a) where specific responses to the questions posed were provided by the respondents, respondents agreed with EFRAG's initial assessment as summarised above; and

(b) none of the other respondents indicated that they disagreed with EFRAG's initial assessment.

EFRAG's final analysis of the costs and benefits of the amendments to IFRS 1

23 Based on its initial analysis and on stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of implementing the Amendments in the EU is presented in the paragraphs below

24 IFRS 1 sets out exemptions to the normal requirements of IFRS that can be applied when an entity prepares its first set of financial statements in compliance with IFRS. The exemptions in IFRS 1 provide some relief from the normal requirements that would otherwise apply in order to ensure that the costs of adopting IFRS do not exceed the benefits.

25 The Amendments include additional exemptions in IFRS 1. The IASB's intention is that the additional exemptions in the Amendments should provide relief from the full retrospective application of IFRS for the measurement of oil and gas assets and for the determination of whether an arrangement involves a lease.

Costs for preparers

<u>Deemed cost for oil and gas assets and implications for decommissioning, restoration and similar liabilities</u>

26 EFRAG believes that an entity electing to take advantage of the deemed cost exemption available under the Amendments would be required for each oil and gas property to:

(a) determine an amount to allocate to the property based on its pro rata share of reserve quantities or reserve values, and

(b) determine a 'value in use' under IAS 36 for the property as part of a transition date impairment test.

27 EFRAG thinks the cost to preparers of using fair value as the deemed value of oil and gas assets would be approximately the same as the cost to determine a 'value in use' under IAS 36. Thus, because the deemed cost approach involves calculating value in use and doing some other things (determining an amount to allocate to oil and gas assets and carrying out an impairment test), EFRAG's assessment is that, compared to the existing fair value exemption, there will be an incremental one-time cost incurred by a preparer electing to measure its oil and gas properties at deemed cost.

28 Entities that elect to use the deemed cost exemption would be required to recognise any difference as at the IFRS transition date between decommissioning, restoration and similar liabilities measured in accordance with IAS 37 and those liabilities measured under their predecessor GAAP directly in retained earnings. EFRAG believes this additional requirement will provide one-time cost savings to those preparers as they will not need to estimate the amount that would have been included in the cost of the asset when the liability first arose and the subsequent accumulated depreciation.

29 EFRAG believes the additional costs referred to in paragraph 27 above and the cost savings referred to in paragraph 28 will probably broadly balance each other out.

30 EFRAG's assessment is that the deemed cost and decommissioning, restoration and similar liability amendments will involve preparers in no additional ongoing costs.

31 Perhaps more importantly, EFRAG notes that entities are not forced to use these amendments—they are optional—and will therefore use them only when they perceive the benefits to exceed the costs they will incur in implementing them.

<u>Reassessment of lease determination</u>

32 The third amendment imposes no additional burdens on preparers; rather, it relieves a burden than currently exists for some entities. EFRAG's assessment is that this will result in year one cost savings for those preparers affected by the amendment. It is unlikely that there will be any ongoing cost implications.

Costs for users

33 Prior to the deemed cost amendment, users would have had to deal with some entities using fair value and some using IFRS-based cost. Now some entities might use a deemed cost which could be calculated in a multitude of different ways. So, there will be a comparability issue; and in many cases also a quality of information (ie relevance) issue because deemed cost will not be as good a number as the number IFRS would have required an entity to present prior to the amendment. Thus, users are likely to incur additional analysis costs, both in year one and on an ongoing basis, to manage the comparability issue and to overcome the relevance issue. The other two amendments will have similar implications. EFRAG's assessment is however that these additional costs will not be significant.

34 Furthermore, EFRAG notes that the Amendments make it possible for such companies to transition to IFRS, and the more entities that are on the same set of accounting requirements, the lower the costs for users. EFRAG's assessment is that the result is likely to be significantly reduced costs for users.

35 EFRAG's overall assessment is that the benefits for users described in the preceding paragraph are likely to outweigh the additional costs for users described in paragraph 33.

Benefits for preparers and users

36 EFRAG's assessment is that the Amendments will not result in any benefits to preparers or users not already taken into account in the above assessments.

Conclusion

37 EFRAG's overall assessment is therefore that:

(a) implementing the deemed cost and decommissioning, restoration and similar liability amendments is likely to be cost neutral, both in year one and on an ongoing basis, and implementing the lease determination amendment will result in year one cost savings and no change in ongoing costs. In any event, implementing the Amendments is optional, so preparers will implement them only if they believe the benefits that are likely to arise from implementation will exceed their implementation costs;

(b) the Amendments are likely to involve users in additional but insignificant costs. On the other hand, the Amendments will make it possible for more entities to adopt IFRS, and EFRAG's assessment is that overall users will benefit from the Amendments.

38 EFRAG's assessment is therefore that the benefits arising from implementation of the Amendments in the EU are likely to exceed the costs of implementation.

39 During its consultation process, EFRAG did not become aware of any other factors that should be taken into account in assessing the costs and benefits of implementing the Amendments in the EU.

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