

Oil Industry Accounting Committee

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Dear Ms Sansom

Draft FRSs 100, 101 and 102

Introduction

The Oil Industry Accounting Committee (OIAC) welcomes the opportunity to comment on draft FRSs 100, 101 and 102 issued by the Accounting Standards Board ('the Board'). This letter follows our letter of 28 April 2011 responding to the previous proposals for UK GAAP. Once again, we have limited our comments to specific oil and gas industry matters, rather than responding to each of the questions in the exposure draft.

As regards the three new draft FRSs –

1. **Reduced disclosures for subsidiaries:** We expect that many oil and gas companies will be relieved to see the terms of draft FRS 101 'Reduced Disclosure Framework' but we have not considered this topic in detail since it is generic rather than specific to upstream oil and gas.
2. **Exploration and Evaluation Expenditures:** We remain extremely concerned that draft FRS 102 does not seem to have taken into account our April 2011 comments suggesting that companies implementing UK GAAP should be allowed to follow the options set out in IFRS 6 'Exploration for and Evaluation of Mineral Resources'. Our comment in April 2011 was as follows:

E&E expenditure can be a significant component of activity for companies, particularly in their early years, and practice in the SORP, and EU adopted IFRS, is that these costs can be capitalised initially and will then be tested for impairment if required.

Our reading of the exposure draft is that this approach will no longer be permitted under the FRSME, although capitalisation will still be allowed under EU adopted IFRS. Whilst section 18 of the exposure draft scopes out 'mineral rights and mineral reserves, such as oil, natural gas and similar non-regenerative resources', paragraph 34.11 states that 'An entity using this FRS that is engaged in the exploration for, evaluation or extraction of mineral resources ... shall account for the expenditure on the acquisition or development of ... intangible assets for use in the extractive industries by applying Section 18 Intangible Assets other than Goodwill'. Therefore we believe it is necessary to use the principles in section 18 to consider whether E&E costs incurred can be capitalised and when they should be tested for impairment. If this is not the ASB's intention of the combination of these sections we think this should be clarified, as this is how our members have interpreted the exposure draft.

If we have interpreted the exposure draft correctly, this means that only E&E assets acquired separately or as part of a business combination could be capitalised, and that any spend by a company on their own assets would have to be immediately expensed as it would fall under paragraph 18.4 (c). We do not believe this is an appropriate accounting approach and would have a significant impact on most oil and gas companies, impacting their presentation of financial performance and distributable reserves.

One possible solution we suggest would be to give companies using the FRSME the option to use IFRS 6 to account for their E&E spend. This would allow those non-publically accountable companies who have aspirations to grow and list to start off with policies on E&E which they would not have to change on transition. Their only alternative, if they wish to capitalise E&E is to report under EU adopted IFRS, but this would add significant costs for compliance with other aspects of IFRS. Making this small change would also enable companies adopting the FRSME to use guidance which exists in the SORP relating to common activities for early stage companies, e.g. farm-ins and carried interests in the E&E phase. This guidance is still used by companies reporting under EU adopted IFRS.

Obviously, references above to FRSME and its paragraphs need to be updated to draft FRS 102, but the concern remains the same. We do not consider it appropriate to force small to medium sized companies reporting under UK GAAP to have to adopt a far more conservative accounting policy than applies to their larger, quoted peers applying IFRS. Indeed we consider that if this issue is not clarified, many existing and future UK unquoted oil and gas companies will decide that they will adopt IFRS rather than use the option of applying UK GAAP, which seems a strange and probably unwanted effect of the ASB proposal as currently drafted.

3. **Transition arrangements for Full Cost companies:** At present, under the SORP, the full cost pools include both exploration/evaluation and development costs. Under FRS102, whether IFRS 6 is adopted or not, the costs of exploiting the reserves are treated separately from the costs of finding them and determining their commerciality, both for initial capitalisation and subsequent impairment testing. Some companies would face a huge task going back over many historic accounting periods to separate them accurately and a simpler process would be required. When Canada was converting to IFRS, which like UK had many small Full Cost Accounting companies, special transition rules were introduced into IFRS 1 to mitigate this problem. At present FRS 102 35.10(j) appears to address the issue of transition for extractive activities' full cost assets but does not provide guidance on whether and how these costs should be split between development and exploration.
4. **Other issues:** Whilst not exclusively an oil and gas industry matter, and therefore technically not within our remit, we are satisfied that the particular concern about the capitalisation of interest that we referred to in our April 2011 letter does appear to have been changed in draft FRS 102.

Since the April 2011 letter, OIAC has re-examined all the sections of the 2001 SORP 'Accounting for Oil and Gas Exploration, Development, Production and Decommissioning Activities' in the light of the many subsequent changes to accounting standards, notably in IFRS. As much of the SORP has been superseded by subsequent accounting standards, including the requirements of the FRS's 100,101 and 102, we have concluded that the main function of the SORP – setting out best practice in relation to these particular industry activities that were not covered directly by the main body of UK accounting standards – is no longer applicable. Conversely, the SORP's secondary role – a sort of "how to do it" manual for people new to the industry, returning to it after an absence, or simply brushing up on a particular treatment – is still entirely relevant. We anticipate setting up web-based guidance notes referencing UK GAAP and IFRS standards, as applicable, to fulfil this role, which has in the past been met by the SORP. These guidance notes will be primarily educational and will not carry the weight of the SORP. They will also be subordinate to the likely more detailed guidance available to all companies from their auditors and financial advisers. Further, with the many subsidiary companies currently reporting under UK GAAP likely to follow FRS 101 and the smallest entities taking advantage of FRSSE, unless there is a change in AIM companies' requirement to report under IFRS, we suspect the actual population of upstream oil and gas companies using FRS 102 supplemented by a SORP will be small. Accordingly, following our review, we do not believe it would make sense for OIAC to update the 2001 SORP.

OIAC stands ready to resume its previous role of SORP-making body if we or the ASB identify particular new issues in the UK upstream oil and gas industry where something more directive than guidance is required. OIAC's other areas of activity, notably reviewing and commenting on proposed new standards that may affect the UK upstream oil and gas industry in ways different from companies generally (and especially the IASB's extractive activities programme, whenever that may emerge) will continue.

I and other members of OIAC would be happy to discuss the above points with you. In particular, should you wish to review our conclusions about the individual activities covered by the SORP and thus the logic of updating it, or not, I would be happy to arrange a further meeting with you and your colleagues.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Alan Thomas', with a large circular flourish above the end of the name and a long horizontal line extending to the right.

Alan Thomas
Chairman OIAC