

Applying IFRS

Accounting considerations
related to recent declines
in oil and gas prices

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What you need to know

- ▶ Oil and gas entities need to consider whether recent declines in oil and natural gas prices create accounting risks, such as counterparty credit risk, impairment risk or going concern risk.
- ▶ Other entities that do business with entities in the oil and gas industry, particularly suppliers, customers and lenders, need to consider accounting risks, especially those associated with credit risk and impairment.
- ▶ Entities that report on internal control over financial reporting also need to consider whether their existing processes and controls are sufficiently precise to identify and mitigate risks posed by lower oil and natural gas prices.

Overview

Recent declines in worldwide crude oil and natural gas prices may create a number of accounting and disclosure implications for oil and gas entities. There may also be an effect on their suppliers, customers, lenders and others, who either directly or indirectly rely on or do business with entities in the oil and gas industry.

The outlook for prices in 2020 and beyond remains uncertain, due to factors that include:

- ▶ The lack of an agreement on production levels by members of the Organization of the Petroleum Exporting Countries (OPEC) and other oil- and gas-producing countries, which could result in production outstripping demand
- ▶ The effects of the coronavirus (COVID-19) pandemic, which has decreased demand for oil and gas products and services as entities and other organisations around the world have suspended or curtailed operations and travel
- ▶ Uncertainty about the future demand for oil and natural gas that predates the coronavirus pandemic due to factors such as the transition to cleaner energy

This publication addresses specific matters for consideration by oil and gas entities. For more information on the broader impacts of COVID-19 refer to our [*Applying IFRS - Accounting considerations of the coronavirus outbreak \(Updated March 2020\)*](#).

1. Considerations for oil and gas entities

Depending on their facts and circumstances, oil and gas entities need to consider how recent declines in oil and gas prices could affect their accounting in the following risk areas:

1.1 Revenue recognition

Declines in crude oil and natural gas prices could affect revenue estimates in new and ongoing customer contracts that are within the scope of IFRS 15 *Revenue from Contracts with Customers*. This will be a concern, particularly for oilfield service, midstream and logistics entities, that have revenue contracts with upstream entities. This is because when a contract with a customer includes variable consideration (e.g., discounts, refunds, price concessions, performance bonuses and penalties), an entity is generally required to estimate, at contract inception, the amount of consideration to which it will be entitled in exchange for transferring promised goods or services. The amount of variable consideration an entity may include in the transaction price is constrained to the amount for which it is highly probable that a significant reversal of cumulative revenue recognised will not occur when the uncertainties related to the variability are resolved.

Updating estimates of variable consideration in a contract with a customer, and the extent to which it should be constrained, may be challenging in the current low oil price environment.

An entity that makes such an estimate is also required to update the estimate throughout the term of the contract to depict conditions that exist at each reporting date. This will involve updating the estimate of variable consideration (including any amounts that are constrained) to reflect an entity's revised expectations about the amount of consideration to which it expects to be entitled. Entities also need to consider the impact on the amount and timing of revenue recognition in take or pay contracts for products, such as natural gas, where current conditions may mean the customer is not capable of taking delivery of the commodity.

Declines in prices could also prompt entities to modify contracts with customers or reassess whether it is probable that the entity will collect the consideration to which it is entitled. As a consequence of COVID-19, which is contributing to the low oil price, oilfield services entities may find it more difficult to obtain payment for variation orders, and upstream, midstream and downstream entities may see customers invoke *force majeure* clauses (if applicable). Furthermore, entities may see customers wanting to invoke repricing clauses in long-term liquefied natural gas (LNG), natural gas or liquids supply contracts.

If both parties to a contract agree to amend the scope or price (or both) of a contract, an entity accounts for the modification under the requirements in IFRS 15.¹ Significant judgement is required to determine when an expected partial payment indicates that: (1) there is an implied price concession to be accounted for as variable consideration; (2) there is an impairment loss (see *Financing receivables and contract assets* below); or (3) the arrangement lacks sufficient substance to be considered a contract under the standard. Some contracts may no longer fall within the scope of the model in IFRS 15 as a result of significant changes in facts and circumstances (e.g., if a customer's ability to pay the consideration deteriorates significantly).

¹ IFRS 15.18-21.

Recent declines in oil prices and the consequent impact on future economic conditions may impact credit risk associated with receivables and contract assets.

1.2 Receivables and contract assets

Oilfield service, midstream and logistics entities should challenge the appropriateness of their allowances for receivables and contract assets, with a particular focus on receivables from upstream entities. Upstream entities also need to consider credit risk in any joint arrangements and the recoverability of any receivables due from joint operators.

Entities applying IFRS 9 *Financial Instruments* are required to consider reasonable and supportable forecasts of future economic conditions in the estimate of expected credit losses. Affected entities that apply IFRS 9 will need to consider how and to what extent recent declines in oil and gas prices should change forecasts of future economic conditions. In particular, entities should consider whether there is an increase in the probability that customers may be unable to repay their obligations when due. While forecasted economic conditions may not significantly affect credit loss estimates for short-term receivables and contract assets when the economy is stable, we believe affected entities need to challenge these assumptions in the current environment.

If payment terms are extended in light of the current economic circumstances, the terms and conditions of the extension will have to be assessed to determine their impact on the expected credit loss estimate as well as any other accounting impacts. For example, if the payment terms of a receivable are extended from 90 days to 180 days, this would likely not be considered a substantial modification of the receivable. However, such extension is expected to result in an increase in probability of default, which would, in turn, affect the measurement of expected credit loss. For entities that do not apply the simplified model, such extension may result in moving into stage 2 of the expected credit loss model, depending on the extent and detailed terms of the payment extension. Nevertheless, if the same extension of payment terms is offered to an entire class of customers irrespective of individual circumstances, this should generally not result, by itself, in a stage movement.

IFRS 9 requires entities to pool financial assets based on similar risk characteristics, but allows them to choose which risk characteristics to use. Affected entities may need to assess whether assets in pools continue to display similar risk characteristics or determine whether they need to revise their pools or perform an individual assessment of expected credit losses.

There are uncertainties about what the effects of the recent declines in oil and natural gas prices will ultimately be. Entities should consider highlighting these risks in their qualitative and quantitative disclosures about credit risk and the allowance for credit losses, ensuring that the full range of reasonably possible outcomes are disclosed.

1.3 Inventory valuation

Weak demand for oil and natural gas may trigger the need for a lower of cost and net realisable value test for crude oil, natural gas and other commodity inventories. This also includes other commodity inventories whose value generally moves in the same direction as crude or natural gas prices (e.g., transportation fuels, natural gas liquids).

In assessing the net realisable value of inventory, entities should be aware of rising storage costs as inventories of crude oil and refined products rise sharply, driven by a steep and sudden decline in demand.

Firm purchase commitments should be included in the inventory analysis, and entities should be aware of rising inventory levels because of take or pay contracts where the customer is not capable of taking delivery of the commodity. Inventory that has been designated as the hedged item in a fair value hedge would be assessed for impairment after hedge accounting has been applied for the period.

1.4 Impairment analyses

Entities may need to analyse whether property, plant and equipment and other non-current assets, equity accounted investments, and intangible assets are impaired using the model prescribed by applicable IFRS. In some cases, they may need to revise the useful lives of certain assets. For those assets (goodwill, indefinite life intangible assets and intangible assets not yet available for use) where IAS 36 *Impairment of Assets* requires an annual impairment test (which does not have to be performed at year end), impairment indicators may demonstrate that the assessment should be updated as at the reporting date.

Impairment indicators may exist, especially for oil and gas properties and oilfield services-related equipment. Recent declines in prices could affect producers' impairment analyses of oil and gas properties. Oilfield services entities may find that cancellations or delays in development plans of their customers mean that equipment carrying amounts may not be recoverable because of reductions in rates and current and future utilisation. Midstream and downstream entities also may be affected by changes in a producer's drilling plans.

An entity should carefully evaluate the appropriateness of inputs and assumptions, especially long-term price and volume forecasts that are used to develop prospective financial information for these impairment analyses.

Management must assess external data points for long-term commodity price assumptions. The commodity price assumptions need to match the profile of the life of the oil and gas asset. Spot prices and forward curve prices (where they are available as at the impairment testing date) are more relevant for shorter life assets, while long-term price assumptions are more relevant for longer life assets. Forecast prices (where available) should be used for the future periods covered by the value-in-use (VIU) calculation. These assumptions will have to be continually reassessed, as the impact of short-term market changes on long-term market dynamics becomes more apparent.

Disclosure of the actual commodity prices used in the impairment analyses would be appropriate even if the entity does not have any goodwill or indefinite life intangibles. While this disclosure is not specifically required by IAS 36, commodity prices would generally be considered a significant assumption or estimate and, hence, would require disclosure under IAS 1 *Presentation of Financial Statements*.

If an entity narrowly avoids recording an impairment based on its analysis, management should consider the sensitivity of its analysis to various assumptions and evaluate corroborating and contrary evidence that is

Entities should carefully evaluate the appropriateness of inputs and assumptions used for impairment testing, especially long-term price and volume forecasts used for prospective information.

reasonably available and make the appropriate disclosures. Such disclosures are required under IAS 1² even where cash generating units do not have goodwill allocated.

How we see it

Entities should consider whether inputs and assumptions used in an impairment analysis are consistent with those used for other purposes, such as presentations to the board of directors, budgeting and forecasting. In addition, discount rates should reflect the level of uncertainty associated with pricing or other assumptions (e.g., growth, volume) inherent in the projected financial information.

1.5 Oil and gas reserves (including effects on depreciation and impairment)

The recent declines in oil and gas prices could affect reserve reporting and disclosure. If material reserves volumes are derecognised, or classification of reserves change, an entity should consider the effects on depreciation, depletion and amortisation rates and impairment analyses.

Many IFRS reporters follow the Petroleum Resources Management System (PRMS) framework issued by the Oil and Gas Reserves Committee of the Society of Petroleum Engineers (SPE). The PRMS includes guidelines with respect to classification and categorisation of resources, evaluation and reporting, and estimation of recoverable quantities. Typically, IFRS reporters that are not dual reporting entities with Securities and Exchange Commission (SEC) reporting requirements, will report proved and probable reserves (2P reserves) under the PRMS framework.

Oil and gas entities should challenge whether their 2P reserves continue to meet the PRMS reserves recognition criteria in the current environment, particularly when there are changes in pricing or their ability to obtain any necessary financing. This evaluation includes challenging whether counterparties (e.g., joint operators) are reasonably certain to be able to provide financing when the development of reserves depends on that financing. This evaluation could lead to the derecognition of 2P reserves. Similarly, an entity should reconsider its assumptions about the production life of 2P reserves (e.g., an entity's expectations for when the wells cease to be economic).

For dual reporting entities, we understand that the SEC staff expects proved undeveloped reserves (PUDs) to be recognised only when there is reasonable certainty about the geological data, management's final investment decision about its development plans and the availability of financing to perform the development activities, among other things. Furthermore, the SEC supplemental oil and gas information disclosure for public upstream entities is also likely to be significantly affected by the recent declines in prices, because the SEC's Rule 4-10(a)(22)(v) of Regulation S-X requires the use of a 12-month average price for proved reserve estimates.

² IAS 1.125-133.

There is a risk of reserves becoming uneconomic because of the steep decline in oil price. This may have consequential impacts for impairment outcomes and depreciation calculations.

1.6 Disposals and assets held for sale

Entities that have decided to dispose of an asset group should consider whether it meets the criteria for recognition as an asset held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Additionally, entities should monitor whether assets that were previously classified as held for sale continue to meet the held for sale recognition criteria, given the current economic environment. For example, assets that previously met the definition of held for sale may no longer meet that definition, if entities are not prepared to sell at current estimates of fair value less costs to sell. Potential buyers may also no longer have the funding capacity to undertake an acquisition.

Assets held for sale are carried at the lower of carrying value or fair value less costs to sell (if that is less than the carrying value of the asset group) using market participant assumptions. Entities should carefully consider inputs and assumptions, including contrary evidence, when estimating the fair value of a disposal group.

If the held for sale criteria are met or the asset group has been disposed of, the entity also needs to assess whether the asset group qualifies for treatment as a discontinued operation.

1.7 Restoration and decommissioning provisions

Changes in estimates of 2P reserves and drilling plans, as well as the effect of pricing pressure on support services, may affect the timing, amount and probabilities of expected cash flows associated with plugging wells or decommissioning other oil and gas assets and associated infrastructure. This added uncertainty could affect the accounting for restoration or decommissioning provisions. For example, near-term costs may be reduced in periods of lower oil and gas prices, while longer-term costs may be expected to rise if and when oil and gas prices recover. Entities should consider the degree to which this price pressure may bring forward the timing of decommissioning.

Changes in the certainty of the cash flows may lead to changes in probabilities assigned to expected cash flow scenarios when estimating asset retirement obligations. Declines in government bond rates as at reporting date may result in an increase in the provision recorded at balance sheet date, while any movements in government bond rates after reporting date are not adjusted for in the provision recorded. In the event that an entity chooses to adjust the discount rate to reflect estimation risk, this adjustment would decrease the discount rate used. Any corresponding increases in restoration and decommissioning assets arising from changes in the provision may lead to impairment triggers being present.

1.8 Derivatives and hedging activities

Entities with derivative instruments may experience substantial gains or losses on these instruments, which could affect collateral requirements and liquidity. Changes in a derivative counterparty's credit risk or an entity's own non-performance risk could also affect fair value estimates of derivatives and hedge effectiveness. Mergers and acquisitions or disposals of businesses could result in changes to derivative counterparties, called novations, which also could affect derivative valuations.

Changes in counterparty credit risk or own non-performance risk could affect fair value estimates of derivatives and hedge effectiveness.

In addition, entities need to consider the effect of ongoing price volatility in determining whether their hedging relationships continue to be effective. This is particularly relevant in situations where there is a basis difference between the hedging instrument and the hedged item. If an entity has designated a transaction such as the purchase or sale of goods or the expected issuance of debt, as a hedged forecasted transaction in a cash flow hedge accounted for under IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9, the entity will need to consider whether the transaction is still a 'highly probable forecasted transaction'. For example, if the decrease in oil prices affects the probability of hedged forecasted transactions occurring during the time period designated at the inception of a hedge, an entity will need to determine whether it can still apply hedge accounting to the forecasted transaction or a proportion of it:

- ▶ If an entity determines that a forecasted transaction is no longer highly probable, but still expected to occur, the entity must discontinue hedge accounting prospectively.³ In this case, the accumulated gain or loss on the hedging instrument that has been recognised in other comprehensive income will remain recognised separately in equity until the forecasted transaction occurs.
- ▶ If an entity determines that a forecasted transaction is no longer expected to occur, in addition to discontinuing hedge accounting prospectively, it has to immediately reclassify to profit or loss any accumulated gain or loss on the hedging instrument that has been recognised in other comprehensive income.

1.9 Debt, debt covenant violations or repayment accelerations

Market volatility may lead to liquidity issues, debt covenant violations or redetermination events (periodic reassessments of the value of collateral by the lender) that affect an entity's rights and obligations under its long-term debt agreements. For example, the recent declines in oil prices could reduce the value of underlying reserves used to support reserve-based lending arrangements. These issues could, in turn, affect debt classification, require waivers from lenders, affect liquidity or result in potential going concern issues. When there are debt covenant violations or other defaults at the balance sheet date, entities should consider the debt classification guidance in IAS 1 to determine the appropriate classification of the debt.

To address liquidity issues, some entities may use more complex debt or equity instruments that could have accounting consequences. Entities should carefully evaluate the nature and terms of these agreements to determine whether they are debt or equity instruments and whether they contain embedded derivatives or other features that require special accounting treatment. The terms of these arrangements also may affect presentation and disclosures.

³ As a reminder, a reduction in the designated quantity of the hedged item because some cash flows are no longer highly probable is not included in the IFRS 9 concept of 'rebalancing', which otherwise allows adjusting the designated quantities of hedged items to allow keeping hedge effectiveness.

Declines in oil prices could reduce the value of underlying reserves used to support reserve-based lending arrangements, which could have an impact on debt classification as current or non-current debt.

1.10 Debt modifications

Affected entities may experience cash flow challenges and may need to obtain additional financing, amend the terms of existing debt agreements or obtain waivers if they no longer satisfy debt covenants. In such cases, they will need to consider the guidance provided in IFRS 9 to determine whether any changes to existing contractual arrangements represent a substantial modification or potentially a contract extinguishment, which would have accounting implications in each case.

1.11 Income taxes

A sustained period of low oil, natural gas and refined product prices could introduce uncertainty about an entity's ability to realise deferred tax assets. In assessing the probability of realisation of carry forward tax losses, the impact of the deterioration of the economic outlook must be factored into the forecasts of taxable profits and reversals of taxable temporary differences.

Entities with interim reporting requirements need to make their best estimate of the effective tax rate they expect to be applicable for the full financial year. If a reliable estimate cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate. The estimation of an effective tax rate may be more complex in the current environment for global entities where the overall effective tax rate is impacted by tax rates in individual jurisdictions. The overall effective tax rate can be influenced by government incentives or tax rate changes in the current environment, and the fact that some subsidiaries cannot recognise deferred tax assets for non-recoverable losses in individual jurisdictions.

1.12 Mergers and acquisitions

Some oil and gas entities may take advantage of a low-price environment by acquiring assets or businesses. It is important that entities that make acquisitions properly assess whether they have acquired a business or a group of assets, because the accounting for a business combination differs significantly from that of an asset acquisition. Entities involved in mergers and acquisitions should also make sure they appropriately challenge the inputs and assumptions they use in estimating the fair value of acquired assets and liabilities, especially those based on long-term price and volume forecasts.

1.13 Other considerations

Depending on the facts and circumstances of the entity's operations, there could be other effects from the recent declines in oil, gas and refined product prices. Entities may modify existing contracts, which could require changes to their accounting. Entities also may modify employment agreements, share-based payments, pension or other post-employment benefit programmes or initiate workforce reductions. Each of these may require entities to apply specific accounting requirements.

2. Going concern

IAS 1 requires management to evaluate an entity's ability to continue as a going concern for at least twelve months from the end of the reporting period.⁴ This evaluation must be performed by management for each annual and interim reporting period. Affected entities will need to consider the combined effects of the risks described above and other risks that may indicate uncertainty in their going concern evaluation. Accordingly, management may need to update the cash flow projections (e.g., capital expenditures, availability of credit facilities, debt covenant breaches) it uses in its going concern evaluation.

Disclosures in the notes to annual and interim financial statements are required if management concludes that significant doubt exists about an entity's ability to continue as a going concern.

3. Events after the reporting period disclosures and related accounting

Entities should consider events that occur between the date of the financial statements and the date when they are issued or authorised for issue. Determining whether events in this period should result in adjustments to the financial statements and/or should be considered for separate disclosure depends on the nature of the subsequent event and the accounting topic. This assessment will, in many cases, be highly judgemental, and entities should therefore consider whether disclosures about this judgement is required, under the relevant circumstances.⁵

4. Interim reporting

Entities with interim reporting requirements under IAS 34 *Interim Financial Reporting* may need to consider whether any of the factors described above affect interim financial statements.

In the current circumstances, indicators of impairment are likely to exist at the interim reporting date for oil and gas properties, goodwill, or other intangible assets. Impairment indicators that may be present include internal and external sources of information, such as the decline in crude oil and other commodity prices, a market capitalisation-to-net-assets deficit, a reduction in forecast future cash flows, and the derecognition of reserves. While there can be added complexities of testing for impairment at an interim date, where indicators are present, impairment testing is required.

While the interim financial report includes fewer disclosures than would typically be present in an annual financial report, disclosures are required regarding events and transactions that are significant to understanding the changes in financial position and performance since the end of the last annual reporting period,⁶ and regarding the nature and amount of items affecting assets, liabilities, equity, net income and cash flows that are unusual because of their nature and size of incidence.⁷

⁴ IAS 1.26

⁵ IAS 1.122

⁶ IAS 34.15.

⁷ IAS 34.16A(c).

Entities should consider events that occur between the date of the financial statements and the date when they are issued. Determining whether subsequent events require adjustment is highly judgmental.

If the range of reasonably possible changes in key assumptions has changed significantly since the end of the last annual reporting period, an update of sensitivity disclosures may be appropriate.

While other standards specify disclosures required in a complete set of financial statements, if an entity's interim financial report includes only condensed financial statements as described in IAS 34, then the disclosures required by those other standards are not mandatory. However, if disclosure is considered to be necessary in the context of an interim report, other accounting standards provide guidance on the appropriate disclosures for many of these items.

For example, although IAS 34 does not include a detailed requirement to include sensitivity disclosures, if the range of reasonably possible changes in key assumptions has significantly changed since the end of the last annual reporting period, an update of relevant sensitivity disclosures may be appropriate to meet the disclosure requirements of IAS 34 regarding significant events, unusual items and changes in estimates.

Obtaining an appropriate balance of disclosure in interim financial statements is important. In light of these requirements and depending on the entity-specific facts and circumstances, higher-level disclosures may be sufficient in condensed interim financial statements.

5. Considerations for other industries

Volatile commodity prices can also affect entities doing business with the oil and gas industry. Entities impacted may include suppliers and other service providers for oil and gas entities (e.g., steel pipe manufacturers), lenders and customers (e.g., petrochemical manufacturers) that have direct or indirect exposure to the industry. Some of the issues these entities may need to consider are similar to those of oil and gas entities described above, for example:

- ▶ Estimates of variable consideration in new and ongoing contracts under IFRS 15 and collectability issues related to receivables and contract assets, including the allowance for expected credit losses, especially those associated with upstream and oilfield service entities or others that rely heavily on oil and gas-related revenues
- ▶ Modification/derecognition of financial instruments, since it may be necessary to modify a borrower's payment terms (including giving a borrower more time to pay its debt) if the low-price environment affects a borrower's liquidity
- ▶ Inventory valuation especially for inventories of refined products or for products that have a significant crude component (e.g., petrochemical products) or inventories of steel pipe and other equipment sold to oil and gas entities
- ▶ Asset impairments, especially for property, plant and equipment and intangibles that are used to provide services or manufacture goods to support the oil and gas industry, or those in regions that benefitted economically from the recent boom in oil and natural gas production
- ▶ Derivative valuation and hedge effectiveness implications and related liquidity risks related to collateral requirements that are similar to those previously described for oil and gas entities

6. Internal control over financial reporting

Entities that are dual reporters and are required to report on internal control over financial reporting (ICFR) should consider whether there are any new or heightened financial reporting risks caused by the recent declines in oil and gas prices and whether internal controls continue to be sufficiently precise to mitigate those risks. For example, the controls over a goodwill impairment test may need to be more precise when small changes in assumptions may affect whether the entity recognises an impairment loss. Decreases in earnings of the impacted entities may affect whether existing controls are sufficiently precise to mitigate risks. These decreases also could affect which processes are significant to financial reporting, which may require the entity to identify additional internal controls.

Furthermore, entities with control owners working remotely because of the coronavirus outbreak should consider whether their internal control over financial reporting continues to be designed appropriately. For example, entities should consider whether reviews that take place remotely are appropriately documented.

Next steps

- ▶ Management needs to consider the risks associated with recent declines in oil and gas prices and make sure the entity has an appropriate plan to respond to those risks.
- ▶ Management should discuss its approach to responding to the risks posed by recent declines in oil and gas prices with the entity's auditor and its audit committee (or those charged with governance).
- ▶ Management of dual reporting entities that report on ICFR should make sure the control structure is designed and operating at a level that would mitigate the risks to the financial statements.

About EY's International Financial Reporting Standards Group

A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting to the key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

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