ACCOUNTING POLICIES //

General information

Premier Oil plc is a limited company incorporated in Scotland and listed on the London Stock Exchange. The address of the registered office is Premier Oil plc, 4th Floor, Saltire Court, 20 Castle Terrace, Edinburgh, EH1 2EN. The principal activities of the company and its subsidiaries (the group) are oil and gas exploration and production in the North Sea, Middle East-Pakistan, West Africa and Asia.

These financial statements are presented in US dollars since that is the currency in which the majority of the group's transactions are denominated.

Adoption of new and revised Standards

In the current year, two Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC) are effective for the current period. These are: IFRIC 11: IFRS 2 – 'Group and Treasury Share Transactions' and IFRIC 14: IAS 19 – 'The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction'. The adoption of these Interpretations has not led to any changes in the group's accounting policies and has had no impact on the financial statements of the group.

At the date of approval of these financial statements the group has not applied the following Standards and Interpretations which are in issue but not yet effective:

- Amendments to IFRS 1/IAS 27 – 'Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate'
- Amendments to IFRS 2 – 'Share-based Payment – Vesting Conditions and Cancellations'
- Amendments to IFRS 3 – 'Business Combinations'
- IFRS 8 – 'Operating Segments'
- Amendments to IAS 1 – 'Presentation of Financial Statements'
- Amendments to IAS 23 – 'Borrowing Costs'
- Amendments to IAS 27 – 'Consolidated and Separate Financial Statements'
- Amendments to IAS 32/IAS 1 – 'Puttable Financial Instruments and Obligations Arising on Liquidation'
- IFRIC 12: 'Service Concession Arrangements'
- IFRIC 15: 'Agreements for the Construction of Real Estate'
- IFRIC 16: 'Hedges of a Net Investment in a Foreign Operation'
- IFRIC 17: 'Distributions of Non-cash Assets to Owners'

The directors anticipate that the adoption of these Standards and Interpretations in future periods will have no material impact on the financial statements of the group except for additional segment disclosures when IFRS 8 – 'Operating Segments' comes into effect for periods commencing on or after 1 January 2009.

Basis of accounting

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs) as endorsed by the Council of the European Union.

The financial statements are prepared under the historical cost convention except for the revaluation of financial instruments and certain oil and gas properties at the transition date to IFRS.

The financial statements have been prepared on a going concern basis. Further information relating to the going concern assumption is provided in the Report of the Directors.

The principle accounting policies adopted are set out below.

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the company and entities controlled by the company (its subsidiaries) made up to 31 December each year. Control is achieved where the company has the power to govern the financial and operating policies of an investee entity so as to obtain benefits from its activities.

On acquisition the assets, liabilities and contingent liabilities of a subsidiary are measured at their fair values at the date of acquisition. Any excess/deficiency of the cost of acquisition over/below the fair values of the identifiable net assets acquired is recognised as goodwill/negative goodwill. The interest of minority shareholders is stated at the minority's proportion of the fair values of the assets and liabilities recognised.

The results of subsidiaries acquired or disposed of during the year are included in the income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring the accounting policies used into line with those used by other members of the group.

All significant inter-company transactions and balances between group entities are eliminated on consolidation.

Interest in associates

An associate is an entity in which the group has a long-term equity interest and over which it has significant influence, but not control, through participation in the financial and operating policy decisions of the investee.

The results, assets and liabilities of associates are incorporated in these financial statements using the equity method of accounting. Interests in associates are carried in the balance sheet at cost as adjusted by post-acquisition changes in the group's share of the net assets of the associate, less any impairment in the value of individual investments. Any excess/deficiency of the cost of acquisition over/below the group's share of the net fair values of the identifiable assets, liabilities and contingent liabilities of the associate at the date of acquisition is recognised as goodwill/negative goodwill.

Where a group entity transacts with an associate of the group, unrealised profits and losses are eliminated to the extent of the group's interest in the relevant associate.

Interest in joint ventures

A joint venture is a contractual arrangement whereby the group and other parties undertake an economic activity that is subject to joint control.

Where a group company undertakes its activities under joint venture arrangements directly, the group's share of jointly controlled assets and any liabilities incurred jointly with other venturers are recognised in the financial statements of the relevant company and classified according to their nature.

Liabilities and expenses incurred directly in respect of interests in jointly controlled assets are accounted for on an accrual basis. Income from the sale or use of the group's share of the output of jointly controlled assets, and its share of joint venture expenses, are recognised when it is probable that the economic benefits associated with the transactions will flow to/from the group and their amount can be measured reliably.

Joint venture arrangements which involve the establishment of a separate entity in which each venturer has an interest are referred to as jointly controlled entities. The group reports its interests in jointly controlled entities using proportionate consolidation – the group's share of the assets, liabilities, income and expenses of jointly controlled entities are combined with the equivalent items in the consolidated financial statements on a line-by-line basis.

Where the group transacts with its jointly controlled entities, unrealised profits and losses are eliminated to the extent of the group's interest in the joint venture.

Sales revenue and other income

Sales of petroleum production are recognised when goods are delivered or the title has passed to the customer.

Interest income is accrued on a time basis, by reference to the principal outstanding and at the effective interest rate applicable.

Dividend income from investments is recognised when the shareholders' rights to receive payment have been established.

Oil and gas assets

The company applies the successful efforts method of accounting for exploration and evaluation (E&E) costs, having regard to the requirements of IFRS 6 – 'Exploration for and Evaluation of Mineral Resources'.

(a) Exploration and evaluation assets

Under the successful efforts method of accounting, all licence acquisition, exploration and appraisal costs are initially capitalised in well, field or specific exploration cost centres as appropriate, pending determination. Expenditure incurred during the various exploration and appraisal phases is then written off unless commercial reserves have been established or the determination process has not been completed.

Pre-licence costs

Costs incurred prior to having obtained the legal rights to explore an area are expensed directly to the income statement as they are incurred.

Exploration and evaluation costs

Costs of E&E are initially capitalised as E&E assets. Payments to acquire the legal right to explore, costs of technical services and studies, seismic acquisition, exploratory drilling and testing are capitalised as intangible E&E assets.

Tangible assets used in E&E activities (such as the company's vehicles, drilling rigs, seismic equipment and other property, plant and equipment used by the company's exploration function) are classified as property, plant and equipment. However, to the extent that such a tangible asset is consumed in developing an intangible E&E asset, the amount reflecting that consumption is recorded as part of the cost of the intangible asset. Such intangible costs include directly attributable overhead, including the depreciation of property, plant and equipment utilised in E&E activities, together with the cost of other materials consumed during the exploration and evaluation phases.

E&E costs are not amortised prior to the conclusion of appraisal activities.

Oil and gas assets (continued)

(a) **Exploration and evaluation assets** (continued)

Treatment of E&E assets at conclusion of appraisal activities

Intangible E&E assets related to each exploration licence/prospect are carried forward, until the existence (or otherwise) of commercial reserves has been determined subject to certain limitations including review for indications of impairment. If commercial reserves have been discovered, the carrying value, after any impairment loss, of the relevant E&E assets, is then reclassified as development and production assets. If, however, commercial reserves have not been found, the capitalised costs are charged to expense after conclusion of appraisal activities.

(b) **Development and production assets**

Development and production assets are accumulated generally on a field-by-field basis and represent the cost of developing the commercial reserves discovered and bringing them into production, together with the E&E expenditures incurred in finding commercial reserves transferred from intangible E&E assets, as outlined in accounting policy (a) above.

The cost of development and production assets also includes the cost of acquisitions and purchases of such assets, directly attributable overheads, finance costs capitalised, and the cost of recognising provisions for future restoration and decommissioning.

Depreciation of producing assets

The net book values of producing assets are depreciated generally on a field-by-field basis using the unit-of-production method by reference to the ratio of production in the year and the related commercial reserves of the field, taking into account future development expenditures necessary to bring those reserves into production.

Producing assets are generally grouped with other assets that are dedicated to serving the same reserves for depreciation purposes, but are depreciated separately from producing assets that serve other reserves.

Pipelines are depreciated on a unit-of-throughput basis.

(c) **Impairment of development and production assets**

An impairment test is performed whenever events and circumstances arising during the development or production phase indicate that the carrying value of a development or production asset may exceed its recoverable amount.

The carrying value is compared against the expected recoverable amount of the asset, generally by reference to the present value of the future net cash flows expected to be derived from production of commercial reserves. The cash generating unit applied for impairment test purposes is generally the field, except that a number of field interests may be grouped as a single cash generating unit where the cash flows of each field are interdependent.

Any impairment identified is charged to the income statement as additional depreciation. Where conditions giving rise to impairment subsequently reverse, the effect of the impairment charge is also reversed as a credit to the income statement, net of any depreciation that would have been charged since the impairment.

(d) **Acquisitions, asset purchases and disposals**

Acquisitions of oil and gas properties are accounted for under the purchase method where the transaction meets the definition of a business combination.

Transactions involving the purchase of an individual field interest, or a group of field interests, that do not qualify as a business combination, are treated as asset purchases irrespective of whether the specific transactions involved the transfer of the field interests directly or the transfer of an incorporated entity. Accordingly, no goodwill and no deferred tax gross up arises, and the consideration is allocated to the assets and liabilities purchased on an appropriate basis.

Proceeds on disposal are applied to the carrying amount of the specific intangible asset or development and production assets disposed of and any surplus is recorded as a gain on disposal in the income statement.

Inventories

Inventories, except for petroleum products, are valued at the lower of cost and net realisable value. Petroleum products and under and overlifts of crude oil are recorded at net realisable value, under inventories and other debtors or creditors respectively.

Tax

Income tax expense represents the sum of the tax currently payable and deferred tax. The tax currently payable is based on taxable profit for the year. Taxable profit differs from net profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the balance sheet date.

Tax (continued)

Deferred tax is the tax expected to be payable or recoverable on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and is accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that taxable profits will be available against which deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill/negative goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences arising on investments in subsidiaries and associates, and interests in joint ventures, except where the group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax is calculated at the tax rates that are expected to apply in the year when the liability is settled or the asset is realised. Deferred tax is charged or credited in the income statement, except when it relates to items charged or credited directly to equity, in which case the deferred tax is also dealt with in equity. Deferred tax assets and liabilities are offset when there is a legally enforceable right to set off corporation tax assets against corporation tax liabilities and when they relate to income taxes levied by the same tax authority and the group intends to settle its current tax assets and liabilities on a net basis.

Translation of foreign currencies

In the accounts of individual companies, transactions denominated in foreign currencies, being currencies other than the functional currency, are recorded in the local currency at actual exchange rates as of the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are reported at the rates of exchange prevailing at the balance sheet date. Non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are translated at the rates prevailing at the date when the fair value was determined. Non-monetary assets held at historic cost are translated at the date of purchase and are not retranslated. Any gain or loss arising from a change in exchange rate subsequent to the dates of the transactions is included as an exchange gain or loss in the income statement.

On consolidation, the assets and liabilities of the group's overseas operations are translated at exchange rates prevailing on the balance sheet date. Income and expense items are generally translated at the average exchange rates for the year. Exchange differences arising, if any, are classified as equity and transferred to the group's translation reserve. Such translation differences are recognised as income or as expenses in the year in which the operation is disposed of.

Group retirement benefits

Payments to defined contribution retirement benefit plans are charged as an expense as they fall due. Payments made to state-managed retirement benefit schemes are dealt with as payments to defined contribution plans where the group's obligations under the schemes are equivalent to those arising in a defined contribution retirement benefit plan.

The group operates a defined benefit pension scheme, which requires contributions to be made to a separately administered fund. The cost of providing benefits is determined using the Projected Unit Credit Method, with actuarial valuations being carried out at each balance sheet date. Actuarial gains and losses are recognised immediately in the statement of total recognised income and expense. Past service cost is also recognised immediately to the extent that the benefits are already vested, and otherwise is amortised on a straight-line basis over the average period until the benefits become vested.

The retirement benefit obligation recognised in the balance sheet represents the present value of the defined benefit obligation as adjusted for unrecognised past service cost, and as reduced by the fair value of plan assets. Any asset resulting from this calculation is limited to unrecognised past service cost, plus the present value of available refunds and reductions in future contributions to the plan.

Royalties

Royalties are charged as production costs to the income statement in the year in which the related production is recognised as income.

Leasing

Rentals payable for assets under operating leases are charged to the income statement on a straight-line basis over the lease term.

Financial instruments

Financial assets and financial liabilities are recognised on the group's balance sheet when the group becomes a party to the contractual provisions of the instrument.

Trade receivables

Trade receivables are stated at their nominal value as reduced by appropriate allowances for estimated irrecoverable amounts.

Bank borrowings

Interest-bearing bank loans and overdrafts are recorded at the proceeds received, net of direct issue costs. Finance charges, including premiums payable on settlement or redemption and direct issue costs, are accounted for on an accrual basis to the income statement using the effective interest method and are added to the carrying amount of the instrument to the extent that they are not settled in the year in which they arise.

Trade payables

Trade payables are stated at their nominal value.

Derivative financial instruments

The group uses derivative financial instruments (derivatives) to manage its exposure to changes in foreign currency exchange rates, interest rates and oil price fluctuations.

All derivative financial instruments are initially recorded at cost, including transaction costs. Derivatives are subsequently carried at fair value. Apart from those derivatives designated as qualifying cash flow hedging instruments, all changes in fair value are recorded as financial income or expense in the year in which they arise.

For the purposes of hedge accounting, hedging relationships may be of three types. Fair value hedges are hedges of particular risks that may change the fair value of a recognised asset or liability. Cash flow hedges are hedges of particular risks that may change the amount or timing of future cash flows. Hedges of net investment in a foreign entity are hedges of particular risks that may change the carrying value of the net assets of a foreign entity.

To qualify for hedge accounting the hedging relationship must meet several strict conditions on documentation, probability of occurrence, hedge effectiveness and reliability of measurement. If these conditions are not met, then the relationship does not qualify for hedge accounting. In this case the hedging instrument and the hedged item are reported independently as if there were no hedging relationship. In particular any derivatives are reported at fair value, with changes in fair value included in financial income or expense.

For qualifying fair value hedges, the hedging instrument is recorded at fair value and the hedged item is recorded at its previous carrying value, adjusted for any changes in fair value that are attributable to the hedged risk. Any changes in the fair values are reported in financial income or expense.

For qualifying cash flow hedges, the hedging instrument is recorded at fair value. The portion of any change in fair value that is an effective hedge is included in equity, and any remaining ineffective portion is reported in financial income. If the hedging relationship is the hedge of a firm commitment or highly probable forecasted transaction, the cumulative changes of fair value of the hedging instrument that have been recorded in equity are included in the initial carrying value of the asset or liability at the time it is recognised. For all other qualifying cash flow hedges, the cumulative changes of fair value of the hedging instrument that have been recorded in equity are included in financial income at the time when the forecasted transaction affects net income.

For qualifying hedges of net investment in a foreign entity, the hedging instrument is recorded at fair value. The portion of any change in fair value that is an effective hedge is included in equity.

Any remaining ineffective portion is recorded in financial income or expense where the hedging instrument is a derivative and in equity in other cases. If the entity is disposed of, then the cumulative changes of fair value of the hedging instrument that have been recorded in equity are included in financial income at the time of the disposal.

Derivatives embedded in other financial instruments or non-derivative host contracts are treated as separate derivatives when their risks and characteristics are not closely related to those of host contracts and the host contracts are not carried at fair value with unrealised gains or losses reported in the income statement. Embedded derivatives which are closely related to host contracts, including in particular price caps and floors within the group's oil sales contracts, are not separated and are not carried at fair value.

Fair value is the amount for which a financial asset, liability or instrument could be exchanged between knowledgeable and willing parties in an arm's length transaction. It is determined by reference to quoted market prices adjusted for estimated transaction costs that would be incurred in an actual transaction, or by the use of established estimation techniques such as option pricing models and estimated discounted values of cash flows.

Cash and cash equivalents

Cash comprises cash in hand and deposits repayable on demand, less overdrafts payable on demand.

Cash equivalents comprise funds held in term deposit accounts with a maturity not exceeding three months.

Share-based payments

The group has applied the requirements of IFRS 2 – 'Share-based Payment'. In accordance with the transitional provisions, IFRS 2 has been applied to all grants of equity instruments after 7 November 2002 that were unvested at 1 January 2005.

The group issues equity-settled and cash-settled share-based payments to certain employees. Equity-settled share-based payments are measured at fair value (excluding the effect of non market-based vesting conditions) at the date of grant. The fair value determined at the grant date of the equity-settled share-based payments is expensed on a straight-line basis over the vesting period, based on the group's estimate of shares that will eventually vest and adjusted for the effect of non market-based vesting conditions.

Fair value is measured by use of the Monte Carlo simulation. The main assumptions are provided in note 19.

A liability equal to the portion of the goods or services received is recognised at the current fair value determined at each balance sheet date for cash-settled, share-based payments.

Convertible bonds

The net proceeds received from the issue of convertible bonds are split between a liability element and an equity component at the date of issue. The fair value of the liability component is estimated using the prevailing market interest rate for similar non-convertible debt. The difference between the proceeds of issue of the convertible bonds and the fair value assigned to the liability component, representing the embedded option to convert the liability into equity of the group, is included in equity and is not re-measured. The liability component is carried at amortised cost.

Issue costs are apportioned between the liability and equity components of the convertible bonds based on their relative carrying amounts at the date of issue. The portion relating to the equity component is charged directly against equity.

The interest expense on the liability component is calculated by applying the prevailing market interest rate, at the time of issue, for similar non-convertible debt to the liability component of the instrument. The difference between this amount and the interest paid is added to the carrying amount of the convertible bonds.

Critical accounting judgements and key sources of estimation uncertainty

Details of the group's significant accounting judgements and critical accounting estimates are set out in these financial statements and include:

- carrying value of intangible exploration and evaluation assets (note 8);
- carrying value of property, plant and equipment (note 9);
- proved and probable reserves estimates (note 9);
- decommissioning costs (note 16); and
- derivative financial instruments (note 17).