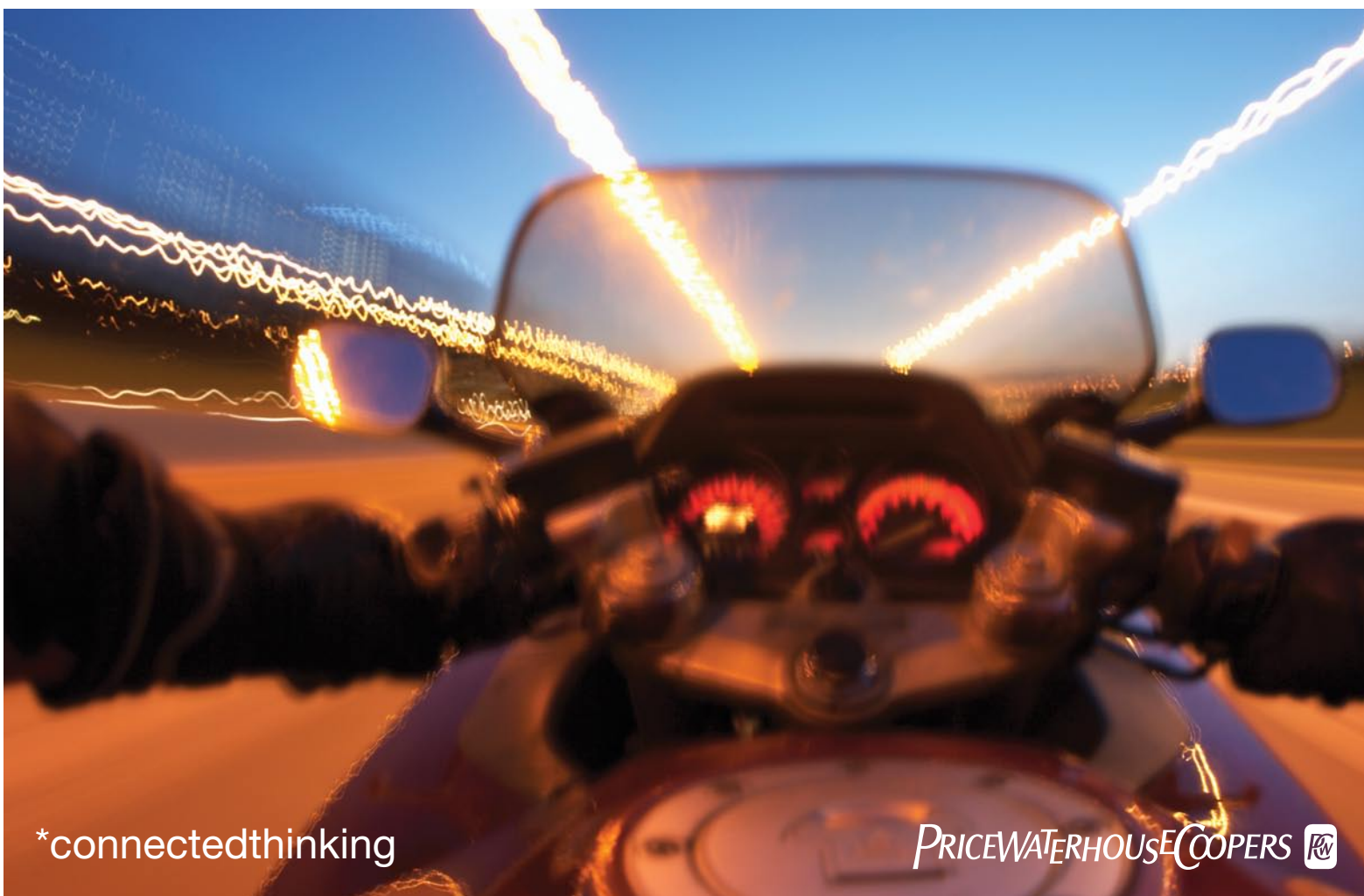


Oil and gas sector  
Putting IFRS in motion

## The potential impact of International Financial Reporting Standards (IFRS) on the Canadian oil and gas sector\*



\*connectedthinking

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## Putting IFRS in motion

More than 70 countries have mandated the use of International Financial Reporting Standards (IFRS) by public companies. In Canada, the Accounting Standards Board (AcSB) has proposed that Canadian GAAP for publicly accountable enterprises migrate to IFRS over a transition period in the next five years. The move to IFRS will change the way many Canadian companies report their business results to analysts, investors and other stakeholders. The oil and gas industry is likely to be one that is significantly impacted by these new standards.

For many organizations, implementing IFRS may be quite a simple process, but for others it may be a highly complex process that goes well beyond the finance and accounting functions. Other business areas such as human resources, investor relations, business development and IT departments, will likely be involved in the IFRS transition plan.

**Companies that have already implemented IFRS know the new standards place a sizeable responsibility on management to be able to communicate effectively to the market in the new language.**

Our experience in assisting numerous global companies that have already adopted IFRS, shows that for some, full conversion and adoption can take anywhere from two to five years, depending on the complexity of the organization.

**Our experience shows that certain industries, such as the full cost oil and gas industry, typically have the longest and most complex conversion process because significant accounting policy changes are required. It is often extremely difficult to extract the historical information necessary to make these changes and the accounting processes and systems have to be modified on a go forward basis.**

## Technical implications

One of the significant challenges in converting from Canadian GAAP to IFRS is determining which GAAP differences will impact the organization. The AcSB intends to work towards eliminating existing differences between Canadian GAAP and IFRS over the transition period, by adopting new IFRS that will continue to emerge as global accounting standard setters continue to harmonize frameworks. Organizations will need to be responsive to take these changes into account in their transition plans.

**Some of the more significant accounting differences that arise between Canadian GAAP and IFRS affect the oil and gas sector, particularly if companies currently follow the full cost method of accounting.**

## Oil and gas accounting under IFRS

The oil & gas sector is characterized by the need for big upfront investment, often with great uncertainty about outcomes over a long-term time horizon. The geopolitical, environmental, energy and natural resource supply and trading challenges, combined with often complex stakeholder and business relationships, has meant that the transition to IFRS has required some complex judgments about how to implement the standards. One example would be how to allocate costs currently tracked in a full cost pool to individual cash generating units (i.e. field level) for impairment testing.

Some of the more challenging business issues for oil and gas companies arise as a result of the following:

- Capital-intensive projects with long lead times;
- High-risk capital projects from which probable future economic benefits cannot be determined until significant exploratory work has been completed;
- Many different forms of risk sharing structures, such as joint ventures, production sharing contracts, undivided interests, co-located assets;
- Industry-specific taxes;
- Co-operation in operating patterns leading to overlift and underlift; and;
- Significant environmental obligations, such as decommissioning requirements and emission limiting schemes.

**The impact of IFRS is felt all along the oil and gas value chain but many of the key dilemmas and judgments are greatest at the exploration and production stage.**

## The future of full cost accounting

At the very start of the value chain, the practice of full cost accounting is limited under IFRS 6 to exploration and evaluation activities. Most of the global integrated oil and gas companies, as well as many smaller upstream companies, use the successful efforts method of accounting for oil & gas activities. Using this method of accounting for exploration and development, costs incurred in finding, acquiring and developing reserves are capitalized on a field-by-field basis, depending on the nature of operations. Upon discovery of a commercially viable (or proven) reserve, the capitalized costs can be allocated to the discovery. In the event that such a discovery is not achieved, the expenditure is charged to expense.



Many companies in Canada have historically used the full cost method of accounting, whereby all costs incurred in searching for, acquiring and developing the reserves in a large geographic cost centre, as opposed to individual fields, are capitalized. These costs include geological and geophysical costs which are generally expensed under the successful efforts method. Cost centres are typically grouped on a country-by-country basis, although sometimes countries may be grouped together if the fields have similar or linked economic or geological characteristics.

The IASB has an extractive industries project underway reviewing the accounting models and practices applied within this industry globally. Based on discussions to date, it is unlikely that the full cost accounting model followed by many Canadian companies will be supported. Until this project is finalized, IFRS 6 was issued to provide an interim solution allowing entities to continue applying their accounting policy in respect of exploration for and evaluation of resources until a more comprehensive solution is developed. Although IFRS 6 provides a solution for accounting for costs incurred in the exploration and evaluation phase, once this phase is completed, all costs incurred must be accounted for on a successful efforts type basis. For many Canadian companies this will have a significant impact on the way they report their results.

**Full cost accounting as applied under Canadian GAAP, in the past, cannot be sustained beyond the exploration and evaluation phase under IFRS.**

## SEC registrants

Currently US registrants are using either full cost or the successful efforts method of accounting for oil and gas activities. One alternative for Canadian SEC registered companies currently using the full cost method of accounting would be to consider adopting US GAAP for reporting purposes. While this is currently possible, there is some risk that Canadian Securities Administrators may rethink their policy of allowing Canadian SEC registrants to adopt US GAAP. There is also the question of whether full cost accounting will be allowed by the SEC over the longer-term, so moving to US GAAP might just delay the problems, not avoid them.

**Before making any decisions as to which GAAP to adopt, it is important to consider where you expect to raise capital in the future and what your peer group is likely to do.**

## Impairment and cash generating units

Once an impairment indicator has been identified, an impairment test must be performed at the individual cash generating unit (CGU) level, even if the indicator was identified at a regional level. A CGU is the smallest group of assets that generates cash flows largely independent of other assets or groups of assets. For example, a fire at an individual gas station may be an indicator of impairment for that station as a separate CGU. A production sharing arrangement is almost always a separate CGU for impairment testing purposes once in production. The level at which exploration and evaluation assets are grouped with producing CGUs must not be larger than the entity's segments.

Currently, Canadian companies following full cost accounting perform the impairment test on the pool of assets; therefore, a dry hole will not necessarily lead to an impairment write-off. On adoption of IFRS, it is necessary for a full cost company beyond the exploration and evaluation stage to break down its full cost pool and account at the individual field (CGU) level. Some companies may have the records to be able to recalculate the historical cost of some or all individual fields, particularly if they were developed or acquired recently but it is often not possible. In Europe, many companies used the IFRS1.16 transition election to measure the field at its fair value at the date of transition to IFRS and subsequently used that fair value as its deemed cost at that date. The Canadian IFRS transition rules have not yet been developed so it is not certain whether such an election will be available for Canadian companies transitioning to IFRS.

**Companies beyond the exploration and evaluation stage using full cost accounting will have significant hurdles to overcome in respect of identifying and tracking individual cash generating units by which to assess impairment and calculate depletion expense.**

IFRS provides detailed guidance on impairment tests for individual assets as well as for CGUs. Although conceptually similar to Canadian GAAP, the absence of the two-step approach may lead to more frequent recognition of impairments, because under Canadian GAAP, the first test is to compare undiscounted cash flows to book value of the assets while IFRS uses discounted cash flows to assess whether an impairment exists. Under IFRS, the amount of the actual write-down could be lower than Canadian GAAP because IFRS requires a company to write its assets down to the recoverable amount defined as the higher of fair value less selling costs or the value in use. A further difference to Canadian GAAP is that IFRS requires companies to reverse previous impairment write-downs if the conditions that caused that impairment no longer exist.

## The elimination of proportionate consolidation

The oil and gas sector is capital intensive. There is a long period of time between application to explore for oil and gas and the first output and positive cash flows. The demand for capital and long lead time has given rise to a practice in the industry of sharing the burden and risk of exploration and start-up with other industry players, governments or users of output.

The IASB has undertaken a research project on joint venture accounting and are expected to issue an exposure draft by June 2007. We understand the IASB has provisionally decided to remove the option of proportionate consolidation for jointly controlled entities, including joint ventures. This would result in Canadian companies being required to change to equity accounting under IFRS for entities in which they have joint control. We note that for companies with an undivided interest in a well, which is generally the case in farm-in and farm-out arrangements, there is not expected to be any change in the current method of accounting upon conversion from Canadian GAAP to IFRS.

## Asset componentization

Large oil and gas assets can comprise a significant number of components, many of which will have differing useful lives. Examples include gas treatment installations, LNG terminals, refineries, major pipelines and big offshore platforms. The cost of the significant components of these types of assets must be separately identified and depreciated to their residual values over the useful life. Identifying the significant components can be a complex process for large and advanced plants. An offshore drilling platform is a major installation that will require decommissioning at the end of its useful life. The platform has a number of components that will require replacement once or more during its working life such as compressors.

**Although the Canadian rules are similar, the application of the IFRS model may require greater rigor than traditionally followed under Canadian GAAP, and the manner in which component depreciation is applied.**

## Asset retirement obligations

Obligations to decommission or remove an asset are created at the time the asset is put in place. An offshore drilling platform, for example, must be removed at the end of its useful life. However, the obligation to remove arises from its placement. If its useful life is 10,000 barrels or 1,000,000, the obligation will not change in substance. Provisions for decommissioning and restoration are recognized even if the decommissioning is not expected to be performed for a long time, for example 80 to 100 years. The effect of the time to expected decommissioning will be reflected in the discounting of the provision under both IFRS and Canadian GAAP. However, under IFRS, the obligation must be discounted at each balance sheet date using the current market-based discount rate whereas under Canadian GAAP, downward revisions in the amount of cash flows would be discounted using the rate applied on initial recognition. Although such interest rate driven changes in the discounted liability do not affect earnings in the period of change (the difference is added to, or deducted from, the cost of the related assets), there could be an impact on balance sheet related ratios and key figures such as debt/equity ratios or capital employed.

## Many more potential GAAP differences

This brochure does not provide a complete list of GAAP differences that Canadian oil and gas companies need to consider upon transition to IFRS. There are other complex and unique areas to be considered such as production sharing arrangements, royalty and excise taxes, pipeline fills and cushion gas and over and underlift agreements.

## Not just a technical accounting exercise

IFRS will present unique challenges for senior management, human resources, the treasury and taxation functions, IT and many other areas across the organization beyond the finance and accounting function. IFRS may impact existing management

reporting including budgets, forecasts, performance measures, bonus structures, key performance indicators and debt covenants. Furthermore, new procedures should be considered to ensure IFRS implications are considered as part of the approval process for all new strategic investments.

### IFRS implementation by 2011

<p><b>Investor relations</b></p> <ul style="list-style-type: none"> <li>• Preparing analysts for the impact of IFRS</li> </ul> <p><b>Management reporting</b></p> <ul style="list-style-type: none"> <li>• Budgets, forecasts, management accounts and KPIs need to be on an IFRS basis</li> </ul> <p><b>Published accounts under IFRS</b></p> <ul style="list-style-type: none"> <li>• Potential impact on tax planning of change in GAAP</li> <li>• New disclosure requirements for IFRS financial statements</li> </ul>	<p><b>Acquisitions</b></p> <ul style="list-style-type: none"> <li>• Need for IFRS figures for due diligence</li> <li>• Modes required for annual goodwill impairment tests</li> </ul> <p><b>Financing/refinancing</b></p> <ul style="list-style-type: none"> <li>• Impact of IFRS on earnings, net assets or debt covenants</li> </ul> <p><b>Remuneration</b></p> <ul style="list-style-type: none"> <li>• Impact of earnings volatility on profit based bonus plans</li> </ul> <p><b>SOX/ICOFR certification</b></p> <ul style="list-style-type: none"> <li>• Process/control documentation updates</li> </ul>	<p><b>Systems and processes</b></p> <ul style="list-style-type: none"> <li>• Need for different/new data</li> <li>• New systems</li> </ul> <p><b>Implementation resources</b></p> <ul style="list-style-type: none"> <li>• Need for resource over 12-18 months</li> <li>• Competing projects</li> <li>• Not just a finance issue</li> </ul> <p><b>Training and education</b></p> <ul style="list-style-type: none"> <li>• All finance staff will need some training</li> <li>• Broader awareness of the issues</li> <li>• Other business professionals within organization</li> <li>• Executives need to be able to understand and explain the “new” numbers</li> </ul>
<p><b>Board of directors / Audit committee governance</b></p>		

## How can PwC help?

The most viable approach to IFRS conversion will vary from one organization to another.

**Our experience has shown that a critical success factor for IFRS conversion is a well-planned implementation which is started well in advance of the required convergence date.**

PwC has unparalleled global experience helping many of the world’s largest public companies adopt IFRS and has assisted with IFRS conversion projects for a wide range of public companies across all industries. PwC provides:

- Initial diagnostic of Canadian/IFRS accounting differences
- Advice on selection of appropriate accounting policies

- Development of IFRS implementation plans
- Communication strategies and change management
- IT and process improvements
- Competitor benchmarking
- M&A target accounting conversion assistance
- Valuation advice under IFRS fair value and impairment models
- Tax planning considerations on conversion to IFRS

## The benefits of using PwC

- A multi-discipline approach
- In-depth diversified experience
- A proven effective and efficient implementation methodology

If you would like to discuss any of the issues raised in this paper, please speak to your usual contact at PricewaterhouseCoopers, or any one of the following Oil and Gas professionals:

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PricewaterhouseCoopers has published the following publications on International Financial Reporting Standards and corporate practices. They are available from your local PricewaterhouseCoopers office and can be found at [www.pwc.com/ifrs](http://www.pwc.com/ifrs).

- Real Time—Delivering International Reporting Standards in the Oil & Gas & Utilities Industries
- IFRS Pocket Guide
- Financial instruments under IFRS
- IAS 39—Achieving hedge accounting in practice
- IFRS Disclosure Checklist 2006
- IFRS Measurement Checklist 2006
- IFRS News—Shedding light on the IASB's activities
- Applying IFRS—PwC's authoritative guidance on the interpretation and application of IFRS. The interactive tool includes links to over 1,000 real-life solutions, as well as direct links to applicable text in the IFRS standards and interpretations.



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