VIEWPOINTS:
Applying IFRSs in the Oil and Gas Industry

SIGNIFICANT IFRS APPLICATION ISSUES

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Background

The Oil and Gas Industry Task Force on IFRSs has put together this list of significant IFRS application issues that junior oil and gas companies should consider in preparing their year-end financial statements.

For resources on the application of IFRSs, visit: **www.cica.ca/IFRS**.

Business Combinations

- IFRS 3 *Business Combinations* broadens the scope of what is considered to be a *business.* More transactions will be considered business combinations rather than asset acquisitions.
- Before recognizing a gain on a bargain purchase, IFRS 3 requires the acquirer to make sure that a bargain purchase has in fact taken place by:
  - Reassessing whether it has correctly identified all of the assets acquired and all of the liabilities assumed.
  - Reviewing measurements to ensure that they appropriately reflect all available information.

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Oil and Gas Industry Task Force on IFRSs

Canada's move to International Financial Reporting Standards (IFRSs) creates unique challenges for junior oil and gas companies. Financial reporting in the sector is atypical due to significant differences in characteristics between junior oil and gas companies and other types of companies. The Canadian Association of Petroleum Producers (CAPP), the Small Explorers and Producers Association of Canada (SEPAC) and the Canadian Institute of Chartered Accountants (CICA) created the Oil and Gas Industry Task Force on IFRSs to share views on IFRS application issues of relevance to junior oil and gas companies. The task force's views are provided in a series of papers that are available through free download. These views are of particular interest to chief financial officers, controllers and auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by the CAPP, SEPAC, CICA or the organizations represented by the task force members.

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- The accounting for a reverse takeover transaction involving a shell company or Capital Pool Company (CPC) that does not meet the definition of a *business* under IFRS 3 differs from the accounting under pre-changeover accounting standards. The application of IFRS 2 S*hare-based Payment* instead of pre-changeover accounting standards EIC-10 *Reverse Takeover Accounting* may result in very different outcomes.

- Share consideration is measured as of the *acquisition date* (i.e., the date on which the acquirer obtains control of the acquiree, which is generally the closing date) in accordance with IFRS 3 rather than the announcement date.

- A royalty payable to the vendor in a business combination should be carefully analyzed and, depending on the substance, may be contingent consideration, a financing arrangement, or a reduction of the purchaser's interest in a property.

Warrants/Convertible Debt

- The application of IAS 32 *Financial Instruments: Presentation* may result in a warrant (or the conversion feature in convertible debt) being classified as a derivative liability (not an equity instrument or a compound financial instrument) for one of the following reasons:
  - The *fixed for fixed* criteria was not met.
  - The issuer or the holder can choose settlement net in cash or by exchanging shares for cash.
  - The shares to be delivered are puttable or impose on the issuer an obligation on liquidation and liquidation is certain to occur (e.g., as in the case of an entity with a limited life).
  - The financial instrument to be delivered contains a derivative (e.g., units consisting of a share and a warrant).

Asset Retirement Obligations

- In cases where future cash flow estimates have not already been adjusted to reflect the risks specific to the liability, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires that the discount rate (or rates) reflect the risks specific to the liability. IAS 37, however, does not specifically state whether the discount rate must reflect *credit risk*. Many Canadian junior oil and gas companies use a *non-credit adjusted risk-free rate.*

- IAS 37 requires that provisions be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. It is important to keep in mind that the discount rate should also be reviewed and adjusted accordingly, not just the future cash flow estimates.

Land Lease Expiries

- IFRS 6 *Exploration for and Evaluation of Mineral Resources* does not specifically address the derecognition of expenditures previously capitalized to exploration and evaluation assets (E&E assets); therefore, an entity may make an accounting policy choice to either:
  - View expired land leases as an indication that the entity should test E&E assets for impairment.
  - Derecognize expired land leases that were capitalized to E&E assets. Many Canadian oil and gas companies have adopted this accounting policy.

Income Taxes

- IFRSs do not specifically address the accounting for flow-through shares or the related tax consequences arising from such transactions. The issue of flow-through shares is in substance: an issue of ordinary shares and the sale of tax deductions.

- IAS 12 *Income Taxes* requires *backwards tracing*, which involves tracking changes in recognized tax assets and liabilities back to components of comprehensive income and equity in which the tax was originally recognized.

- IAS 12 requires disclosure of the aggregate amount of *outside basis* temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognized. Gathering the information to calculate this amount may be challenging.

Farm-Out Arrangements

- Exploration and evaluation (E&E) phase. With respect to gains and losses on farm-out arrangements in the E&E phase, a farmor will typically make an accounting policy choice not to recognize them.

- Development phase or production phase. Gains and losses on farm-out arrangements in the development phase or production phase are recognized by the farmor.

Full Cost Accounting

The following are significant differences from pre-changeover accounting standards AcG-16 *Oil and Gas Accounting—Full Cost:*

- Dispositions and transfers in the pre-acquisition phase, development phase or production phase. More transactions (e.g., asset swaps, sale of working interests and transfers) will be considered to have *commercial substance*, which may result in the recognition of a gain or loss.

- Expenditures incurred in the pre-acquisition phase generally would not qualify for capitalization under IFRSs.
- A well workover may be capitalized (if it is considered major maintenance) or expensed (if it is considered routine maintenance).
- Impairment of assets (other than goodwill):
  - An entity is required by IFRS 6 to determine an accounting policy for allocating E&E assets to cashgenerating units (CGUs) for the purpose of assessing such assets for impairment.
  - E&E assets will typically be tested for impairment at a lower level (i.e., the level of the CGU will often be below the level of the country).
  - IAS 36 *Impairment of Assets* requires that an impairment loss be reversed if there has been a change in the estimates used to determine the recoverable amount.
  - IAS 36 requires that impairment be tested using a lower threshold for recoverability (i.e., calculated using discounted cash flows or fair value instead of undiscounted cash flows).
  - Sufficient appropriate evidence should support the discount rate used in calculating value in use (VIU) and fair value less costs to sell (FVLCTS).
  - FVLCTS should be benchmarked against and calibrated to market transactions.
- Depletion of an oil and natural gas property in the production phase:
  - The useful life of the oil and natural gas property may be estimated using either proven reserves (1P) or proven and probable reserves (2P). If 2P are used, it is important to keep in mind that the depletable amount would include expected future development costs related to undeveloped reserves.
  - IAS 16 *Property, Plant and Equipment* requires that each part of an item of property, plant and equipment (PPE) with a cost that is significant in relation to the total cost of the item be depreciated separately. In the context of an oil and natural gas property, this means that depletion would be determined on a smaller basis (e.g., on a field-by-field basis or area-by-area basis rather than country-by-country basis).
- Reclassification of E&E assets:
  - An E&E asset must no longer be classified as such, in accordance with IFRS 6, when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable.
  - IFRS 6 also requires that E&E assets be assessed for impairment before reclassification.

The Oil and Gas Industry Task Force on IFRSs

Members

Kevin Hamm, CA (Chair)
Canadian Natural Resources Limited
Calgary, Alberta

Leontine Atkins, CA
KPMG LLP
Calgary, Alberta

Steve Aubin, CA
Deloitte & Touche LLP
Calgary, Alberta

Scott Bandura, BMath, MAcc, CA, CPA (Illinois)
PricewaterhouseCoopers LLP
Calgary, Alberta

Dale Brown, CA
Grant Thornton LLP
Calgary, Alberta

Kerry Clark, CA
Ernst & Young LLP
Calgary, Alberta

Steven Glover, MBA, FCA
Calgary, Alberta

Katherine Gomes, CA
ARC Resources Ltd.
Calgary, Alberta

Jim Screaton, CA
Calgary, Alberta

Kathy Turgeon, CA
Peyto Exploration & Development Corp.
Calgary, Alberta

Adrienne Viala, CA
Husky Energy Inc.
Calgary, Alberta

Jonathan Winn, CA, ACA (UK)
BDO Canada LLP
Calgary, Alberta

Observer

Lara Gaede, CA, CFA
Alberta Securities Commission
Calgary, Alberta

Staff

David Daly
Canadian Association of Petroleum Producers
Calgary, Alberta

Gary Leach
Small Explorers and Producers Association of Canada
Calgary, Alberta

John Tang, CA, MAcc
Canadian Institute of Chartered Accountants
Toronto, Ontario

Comments on this Viewpoint or suggestions for future Viewpoints should be sent to:

Alex Fisher, CPA, CA
Principal, International Financial Reporting Standards
Research, Guidance and Support
Chartered Professional Accountants of Canada
277 Wellington Street West
Toronto, Ontario   M5V 3H2

email: afisher@cpacanada.ca

For more information on IFRSs visit:

www.cpacanada.ca/ifrsoilgas