

ASSURANCE AND ACCOUNTING

CANADIAN GAAP – IFRS

COMPARISON SERIES

Issue 17: Oil and Gas Companies

Both IFRS and Canadian GAAP are principle-based frameworks. From a conceptual standpoint, many of the general principles are the same; however, the application of the general principles in IFRS can be significantly different from Canadian GAAP. To understand the magnitude of the differences between the two, it is essential to look beyond the general principles and examine the detailed guidance provided in the standards. This is our seventeenth issue in a series of publications, which will provide detailed information on the key differences between IFRS and Canadian GAAP.

In this issue, concerns regarding the application of IFRS to oil and gas companies will be presented, with focus on:

- Accounting for project costs;
- Accounting for decommissioning liabilities; and
- First time adoption of IFRS issues.

References

IFRS: IFRS 1, First-time Adoption of International Financial Reporting Standards; IFRS 6, Exploration for and Evaluation of Mineral Resources; IAS 16, Property, Plant and Equipment; IAS 23 Borrowing Costs; IAS 36 Impairment of Assets; IAS 37 Provisions, Contingent Liabilities and Contingent Assets; IAS 38 Intangible Assets, IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities.

Canadian GAAP: AcG 16, Oil and Gas Accounting–Full Cost; Section 3110 Asset Retirement Obligations, EIC 159, Conditional Asset Retirement Obligations.

Be advised that this publication is a guide to the differences between Canadian GAAP and IFRS and is not meant to be a comprehensive manual. Please contact a BDO Canada LLP representative for specific details and information.



Scope of IFRS Compared to Canadian GAAP

Canadian GAAP has specific standards that are applicable to oil and gas companies. IFRS does not have such specific guidance.

CANADIAN GAAP	IFRS
AcG 16 provides detailed accounting rules for most aspects of oil and gas activities to be followed by companies using the Full Cost method.	IFRS 6 provides principles for companies to use during the Exploration and Evaluation ("E&E") phase of a project. There are no other specific oil and gas related standards and all other phases are covered by general accounting standards such as IAS 16 which deals with accounting for property plant & equipment, and IAS 36 which deals with impairment testing.
There is no specific Canadian accounting guidance for companies following the Successful Efforts accounting method. The majority of these companies follow US guidance.	
Section 3110 provides specific guidance on the accounting for asset retirement obligations.	IAS 37 is a general liability standard that applies to the accounting for decommissioning costs. IFRS using the term "decommissioning costs" whereas Canadian GAAP uses the term "asset retirement obligation" to describe the same obligation.

Recognition and Measurement

The vast majority of Canadian oil and gas companies follow the full cost method and this comparison focuses on the differences between this method and IFRS. Companies following the Successful Efforts method may find that they encounter less differences.

Pre-exploration costs

CANADIAN GAAP	IFRS
AcG-16 requires companies to capitalize all costs associated with property acquisition, exploration and development activities, within an appropriate cost centre. For cost centres that are in the preproduction phase all costs are required to be capitalized. This means that all costs incurred prior to the acquisition of a mineral right are capitalized under Canadian GAAP.	IFRS 6 only applies to activities undertaken after the acquisition of the legal rights to explore. It does not, therefore, apply to pre-exploration costs. Under IFRS these costs, the most significant of which is likely to be the acquisition of 3D seismic data, must be accounted for under other standards. Generally, companies expense these costs as they do not meet the definition of an asset under IFRS. If they are able to demonstrate that the costs have some resale value, recognition as an intangible asset under IAS 38 may be appropriate.

Exploration and Evaluation costs

CANADIAN GAAP	IFRS
Generally, all exploration and evaluation costs are required to be capitalized within a company's full cost pool. Preparers have some discretion regarding whether or not to capitalize certain overhead costs.	IFRS 6 applies to costs incurred between the date that a company acquires the legal right to explore a particular area and the date when the technical feasibility and the commercial viability of extract are demonstrable. During this phase companies are required to develop accounting policies stating how they will account for the costs incurred. Costs incurred in this phase may include lease acquisition rights, technical studies and services, seismic costs, geologic and geophysical costs, exploratory drilling and testing, attributable general and administration costs. This allows a choice of capitalizing or expensing these costs. Companies may find that the accounting for these costs is similar to those under Canadian GAAP, however, differences may exist as a result of other Canadian GAAP – IFRS differences. For example, if an amount capitalized was a result of related party transaction, differences may result.

<p>Under AcG-16 unproved properties are subject to an impairment test that is based on consideration of the results of any exploration undertaken to date, including drilling dry holes. Any impairment identified is included in costs subject to depletion and depreciation.</p>	<p>IFRS 6 requires an impairment test based on facts and circumstances surrounding the exploration and evaluation assets. The standard gives some examples of circumstances that might indicate impairment, however, this list is not exhaustive. Where there are indicators of impairment, a company is required to undertake an impairment test under IAS 36. (Please refer to Issue 2 of our IFRS-Canadian GAAP Difference Series; www.bdo.ca/library/publications/ifrs/IFRS-CanadianGAAP.cfm). Any impairment would be recognized in net income. Impairment is more fully addressed under 'Producing Activities' below.</p>
<p>AcG-16 allows the costs associated with unproven properties to be excluded from costs subject to depletion and depreciation.</p>	<p>IFRS 6 does not specifically address whether E&E assets should be depreciated, however, it does state that after recognition an entity shall apply the cost or revaluation model under IAS 16 or IAS 38. The revaluation model is rarely used in practice. The cost model would require depreciation over the life of the right to explore, however in practice, the E&E assets are considered to be 'not yet available for use' and therefore no depreciation is recognized.</p>

Development costs

CANADIAN GAAP	IFRS
<p>Under AcG-16, all costs associated with the development of a particular property are capitalized. These costs include that portion of overhead or general and administrative costs that can be directly related to, and is necessary to, the development activity. Allocations, particularly in smaller enterprises, may be required.</p>	<p>Development costs are capitalized under IAS 16. (Please refer to Issue 3 of our IFRS-Canadian GAAP Difference Series; www.bdo.ca/library/publications/ifrs/IFRS-CanadianGAAP.cfm). This standard places more restrictions on costs qualifying for capitalization. General and administration costs are specifically excluded, unless they can be demonstrated to be 'directly attributable'.</p>
<p>AcG-16 states that interest costs related to a development may be capitalized. This would be an accounting policy choice for each company.</p>	<p>IAS 23 <i>requires</i> capitalization of borrowing costs incurred during the construction of a qualifying asset. A qualifying asset is one that necessarily takes a substantial period of time to get ready for its intended use or sale.</p>
<p>Where individual properties are exchanged, generally no adjustment is made to the carrying values of a company's oil and gas assets.</p> <p>When a property is sold no gain or loss is recognized, unless the depletion rate would change by 20% or more.</p>	<p>Under IAS 16 when properties are exchanged the exchange is accounted for at fair value. Any difference between the fair value of the property acquired and the carrying value of the property given up is recognized as a gain or loss. Likewise, any disposal of properties will result in a gain or loss.</p>

Producing Activities

CANADIAN GAAP	IFRS
<p>Under AcG-16 costs associated with proved properties are pooled in cost centres and depleted using the unit of production basis. A cost centre is defined as an individual country.</p>	<p>Under IAS 16 each asset is depreciated individually. IAS 16 goes further and states that each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. Depreciation is recognized over the estimated useful life of the asset (or part thereof). This means that assets with identical useful lives can be aggregated and depreciated in total. If the life of a group of assets is tied directly to a given reserve, it may be appropriate to depreciate them using the unit of production method over the life of the reserve.</p> <p>Assets not tied directly to reserves such as pipelines or processing and storage facilities will need to be depreciated individually over their estimated useful lives. If significant, these assets will need to be split into parts.</p>

Repair costs and workovers are generally expensed under Canadian GAAP.

Where a repair or workover enhances the asset such that additional future economic benefits will be obtained, the cost should be capitalized. To the extent that this work represents the replacement of an existing asset, any carrying amount relating to the replaced asset must be derecognized.

A part of an asset need not have physical form. The costs of major repairs and turnarounds qualify as assets; therefore, these costs are capitalized and depreciated, rather than being accrued for. The amount capitalized is depreciated as a separate component over the period until the next turnaround is expected to be required.

AcG - 16 requires impairment testing (the ceiling test) on an annual basis. This test is conducted on a cost centre basis.

IAS 36 requires companies to identify any indicators of impairment. If a company identifies an indicator then a formal impairment calculation is required.

The test is a two step test. Under the first step the undiscounted future cash flows from a company's proved reserves are compared to the carrying value of their properties. If this test indicates that an impairment may exist, then the second step is performed. In the second step the fair value of the properties is calculated by reference to the discounted estimated future net cash flows from the company's proved and probable reserves. The fair value is compared to the carrying value and any shortfall is recognized as an impairment expense.

When a formal calculation is required, assets are tested either individually or on the basis of Cash Generating Units (CGUs). A CGU is the smallest group of assets that generate cash inflows that are independent from those from other assets or groups of assets. The standard does not define a CGU further, but does give some indications as to how management would identify CGUs. In practice oil and gas companies use a variety of definitions, including well, field, and area of interest. Each assessment is likely to be entity specific. The CGU will almost certainly be a lower level than the cost centre under Canadian GAAP.

Once recognized, an impairment charge is never reversed.

The impairment test is a single step test. Under this test the recoverable amount of the CGU is compared to its carrying value. Any shortfall is recognized as an expense. The recoverable amount is the higher of the fair value less costs to sell of the asset, or its "value in use" which is the discounted cash flows expected to be obtained from using the asset.

Impairment charges can be reversed in future periods if there are indicators of reversal. The amount of reversal is limited such that the carrying amount of the asset after reversal may not exceed the amount that would have been determined had no impairment loss been recognized in prior periods. This has practical implications for preparers as it requires calculation and tracking of depreciation and depletion on both an impaired and non-impaired basis.

Asset Retirement Obligations / Decommissioning Liabilities

(Please refer to Issue 7 of our IFRS-Canadian GAAP differences series for further discussion; www.bdo.ca/library/publications/ifrs/IFRS-CanadianGAAP.cfm)

CANADIAN GAAP	IFRS
<p>Section 3110 requires a company to recognize a liability to discharge a legal obligation to undertake remediation work when an asset is retired. The obligation must be legal, constructive obligations are not considered. EIC 159 does require recognition of some uncertain liabilities, however, even in this case these are legal liabilities.</p>	<p>Under IAS 37 a company is required to recognize the cost of decommission assets, as a liability. This applies to both legal obligations and constructive obligations. Constructive obligations arise where an entity has given an undertaking for certain tasks, even though it has no legal requirement to do so. A common example would be the costs of reclamation work undertaken in countries with less developed environmental legislation than in Canada.</p>
<p>Section 3110 requires the liability to be measured at fair value based on the amount that a third party would charge for performing the remediation work.</p>	<p>The measurement under IAS 37 is based on 'best estimate'. The best estimate calculation can be based on internal or external costs, depending on which is most likely.</p>

Under Section 3110 a liability is re-measured when revisions are made to the amount of timing of the future cash flows associated with settling the liability. These are made on a prospective basis. Changes are not made, if the interest rate used to calculate fair value changes. Generally, any changes to the liability are offset against the carrying value of the related asset.

Under IFRIC 1, Changes in Existing Decommissioning, Restoration and Similar Liabilities changes are also made on a prospective basis, however, this interpretation requires the liability to be re-measured when expected interest rates change.

Changes to the liability are generally offset against the carrying value of the asset, however, changes that arise due to variations in the expected cash flows caused by operations are charged to operating expenses.

Disclosures

CANADIAN GAAP	IFRS
<p>AcG- 16 has the following disclosure requirements:</p> <ul style="list-style-type: none"> (a) Interest and general and administrative costs capitalized during the period; (b) Costs at the balance sheet date excluded from costs subject to D & D, together with comparative amounts; (c) The method used in calculating D & D, i.e., whether gross or net (before or after royalties) numbers were used and how gas and oil were converted to a common unit of measure; (d) The prices used for the benchmark (for example, Edmonton Par, WTI) in each of the first five years for purposes of the impairment test for each cost centre, together with the average annual percentage change thereafter, and a description of adjustments made to these prices to arrive at revenue; (e) The disclosures required by IMPAIRMENT OF LONG-LIVED ASSETS, Section 3063, and by DISPOSAL OF LONG-LIVED ASSETS AND DISCONTINUED OPERATIONS, Section 3475; (f) When planned principal operations in a new cost centre have not commenced: <ul style="list-style-type: none"> (i) The fact that activities in the cost centre are considered to be in the preproduction stage; (ii) The fact that all costs, net of revenues, have been capitalized; (iii) The major uncertainties affecting recovery of costs; and (iv) For each cost centre, net costs to date with respect to unproved properties, proved properties and other costs. 	<p>Under various IFRSs similar disclosure requirements exist as follows:</p> <ul style="list-style-type: none"> (a) An entity shall disclose the amount of borrowing costs capitalized during the period; and the capitalization rate used to determine the amount of borrowing costs eligible for capitalization. (IAS 23.26); (b) The financial statements disclose the amount of expenditures recognized in the carrying amount of an item of property, plant and equipment in the course of its construction (IAS 16.74(b)); (c) The financial statements shall disclose, for each class of property, plant and equipment, the depreciation methods used and the useful lives or the depreciation rates used (IAS 16.73); (d) An entity shall disclose for each material impairment loss recognized or reversed during the period for a cash-generating unit, whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs to sell or its value in use. If recoverable amount is fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether fair value was determined by reference to an active market). If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use (IAS 36.130); (e) IAS 36 requires extensive additional disclosures when losses are recognized or reversed; and (f) The notes to the financial statements shall provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them (IAS 1.112(c)). <p>While these disclosures are similar, there are a significant number of additional disclosure requirements under IFRS and companies should expect that their statements will be more voluminous under IFRS.</p>

First Time Adoption Issues

Due to the significant differences between Canadian GAAP and IFRS outlined above, the first time adoption of IFRS is likely to be a major undertaking of any oil and gas company. The IASB has recognized this and has introduced some optional exemptions under IFRS 1 First-time Adoption of International Financial Reporting Standards (IFRS 1). Under the exemption in Appendix D8A, a company that has used the full cost method of accounting under previous GAAP may elect to measure oil and gas assets at the date of transition to IFRSs on the following basis:

- (a) Exploration and evaluation assets at the amount determined under the entity's previous GAAP. This will usually be equal to the unproved properties excluded from the depletion and depreciation calculation; and
- (b) Assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP.

The company allocates the latter amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date. An impairment test is required on transition; therefore, companies will need to indentify their CGUs prior to transition. This transitional test requires a calculation of recoverable amount, even if no impairment indicators are present. They will also need to identify assets whose lives are not tied to reserves and remove the carrying value of these assets from the full cost pool prior to transition.

Appendix D21A requires companies that have taken advantage of the election available under Appendix D8A to measure their decommissioning liabilities on transition under IAS 37 and to treat any difference between this amount and the amount recognized under previous GAAP as an adjustment to retained earnings.

There is no similar election available to companies following the successful efforts method of accounting.

The Future of Accounting for Extractive Industries

When the IASB issued IFRS 6, it was seen as a 'stop gap' measure until a more comprehensive standard could be issued. The IASB has a project group who have been charged with developing such a standard. This group has been working on the project for a number of years. The group has published a working draft of a discussion paper on the IASB website, however, due to pressure of other items on the IASB's agenda, a revised standard appears to be a long way off. It is therefore likely that oil and gas companies will continue to follow the general standards outlined in this article.

The IASB does have a project to revise IAS 37. This will impact the way in which decommissioning liabilities are measured, in particular it is expected to remove the best estimate measurement basis and replace it with fair value, however, differences compared to Canadian GAAP are expected to remain. It is unlikely that the revised standard will require mandatory adoption prior to January 1, 2011.

Many oil and gas companies operate through joint arrangements, either through investments in working interests or formal joint ventures. The IASB expects to issue a new standard on Joint Arrangements in the first quarter of 2010. The accounting for working interests is expected to remain unchanged from current Canadian practice, although it may well alter the way farm-in and farm-out transactions are recorded. The new standard may, however, restrict the ability of companies to use the proportional consolidation method for accounting for joint ventures, which could have a significant impact. It is unlikely that the revised standard will require mandatory adoption prior to January 1, 2011.

Conclusion

The adoption of IFRS by oil and gas companies will be a major undertaking for each company. While the optional exemption permitted under IFRS 1 will assist in the process, companies will still face significant issues with regards to on-going accounting, including whether or not their systems will be able to produce the required information.

If you require further guidance on oil and gas accounting under IFRS, or any other IFRS information or reference sources, please contact your local BDO Canada LLP Office or visit www.bdo.ca/ifrs/

The information in this publication is current as of February 12th, 2010.

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