

The Application of IFRS: Oil and Gas

Executive Summary

October 2008

Foreword

The global adoption of International Financial Reporting Standards (IFRSs) gained tremendous momentum in 2005 with the adoption of these standards by a number of countries, including in the European Union and Australia. That trend has continued with the decision of the U.S. Securities and Exchange Commission (SEC) to drop the requirement for the reconciliation to U.S. GAAP for foreign private issuers reporting under IFRSs as issued by the International Accounting Standards Board. And there is the prospect of further SEC acceptance of IFRSs – indicated by its decision in August 2008 to propose a “roadmap” for IFRS adoption by U.S. issuers.

The oil and gas industry is one of the most international and so stands to gain significantly. However, there is relatively little IFRS guidance specifically tailored to some of the industry’s particular features: the significant uncertainties around exploration activity; the long lead times between initial investment and first production; the very significant disconnect between the amount spent to explore for, evaluate and develop an oil or gas field and its value; the complex risk-sharing arrangements often involving resource-owning countries and national oil companies; the many and varied ways in which resource-owning countries take their “share” of the economic benefits (through royalties, taxes or production and risk sharing contracts); and the environmental challenges.

It is not surprising then that transitioning to IFRSs has involved oil and gas companies making some complex judgements.

IFRSs took a significant step forward in 2005 with the first wave of countries adopting the standards, and after three years of wide experience, now seems an opportune time to take stock of how oil and gas companies around the world are applying IFRSs in practice.

The survey highlights areas in which IFRSs have been applied with reasonable consistency by the industry; it also highlights areas in which nuances of companies’ previous GAAPs have been carried through to their IFRS accounting policies and disclosures. While some of these nuances manifest themselves in the use of different terminology and minor differences of accounting, others highlight the need to read the financial statements closely when the objective is to make accurate comparisons between companies in the sector.

Improvements in financial reporting are not achieved by mere compliance but through concerted efforts to communicate financial performance with clarity and consistency. The oil and gas industry is making progress in this direction and the outcome of the IASB’s Extractive Activities project, which currently is underway, is eagerly anticipated.

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This executive summary has been drawn from *The Application of IFRS: Oil and Gas*, published in October 2008, and focuses on the results of a survey of the IFRS financial statements of 33 companies in the oil and gas sector across 14 countries. That publication was produced by the KPMG International Financial Reporting Group, in collaboration with KPMG in the UK. To order a copy, go to www.kpmgifrg.com or www.kpmgglobalenergyinstitute.com.

This executive summary should be read in conjunction with that publication in order to understand more fully the findings from the survey. In addition, that publication includes disclosures made by companies in their consolidated financial statements that we believe may be useful in assessing the type of information being disclosed in practice.

KPMG's Global Energy & Natural Resources (ENR) practice is dedicated to assisting all organisations operating in the Oil & Gas, Power & Utilities, Mining and Forestry Industries in dealing with industry trends and business issues. We have a range of publications that can assist you further, including *IFRS 6: Exploration for and Evaluation of Mineral Resources by Oil and Gas companies* (by KPMG in the UK), *Insights into IFRS*, *IFRS: An overview*, *Disclosure checklist*, illustrative financial statements, and illustrative condensed interim financial statements. Technical information is available at www.kpmgifrg.com and www.kpmgglobalenergyinstitute.com.

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Contents

1. Exploration and evaluation (E&E) and development expenditure	4
2. Depletion, depreciation and amortisation (DD&A)	5
3. Decommissioning and environmental provisions	6
4. Interests in joint ventures	7
5. Business combinations	8
6. Farm-ins and farm-outs	9
7. Reserves reporting	10
8. Critical judgements and key sources of estimation uncertainty	11
9. Revenue	12
10. Taxation and other fiscal features	13
11. Derivatives and commodity price risk	14
12. Functional and presentation currencies	15
13. Segment reporting	16

1. Exploration and evaluation (E&E) and development expenditure



The costs involved in E&E and development activities are considerable, and often there are years between the start of exploration and the commencement of production; and even with today's advanced technology, exploration is a risky and complex activity. Additionally, there is no direct correlation between the cost incurred and the value this creates. Accounting for E&E expenditure therefore is a critical element of ensuring that the financial statements of oil and gas companies fairly represent their business activities.

There was no IFRS that addressed specifically E&E activities until IFRS 6 *Exploration for and Evaluation of Mineral Resources* was approved by the IASB in 2005, effective for annual periods beginning on or after 1 January 2006. IFRS 6 was intended to be a temporary standard while the International Accounting Standards Board undertook an in-depth project on extractive activities, aimed at bringing some discipline to the accounting for E&E activities. With that in mind, the standard was written with a view to allowing companies to carry over to IFRSs their previous GAAP practices to a large extent.

Key messages from our survey group

The introduction of IFRS 6 has not made the use of the terms successful efforts accounting and full cost accounting redundant, despite neither term being referred to in IFRS 6. Even though full cost accounting in its pure form is not consistent with IFRS 6, companies either had changed the term subtly to "modified" full cost accounting, or had continued to use the term in conjunction with a change in accounting policies in order to comply with IFRS 6.

All companies capitalised at least some E&E expenditure, the majority classifying the resulting E&E asset as an intangible asset.

A majority of companies included a specific accounting policy for the impairment of E&E assets. However, most companies did not disclose how E&E assets were allocated to cash-generating units.

It was not common for companies to present an accounting policy for pre-E&E (pre-licence) expenditure, but most companies presented an accounting policy for development expenditure.

Most companies classified development assets as property, plant and equipment.

Few companies differentiated between development assets and production assets, with most companies combining these into one class for the purpose of disclosure.

2. Depletion, depreciation and amortisation (DD&A)



Oil and gas companies invest large amounts of time, money and experience in exploring and evaluating potential reserves and resources. The success of many of these companies is measured by the returns that these investments produce. For many oil and gas companies the commencement of production is cause for celebration, as it represents the success of the exploration and evaluation process.

With the current price of oil and gas products reaching record highs, and showing a significant rise in prices compared to previous years, companies that may have decided previously that the extraction of identified resources was uneconomic are reassessing their position. For some companies, as the cost of oil and gas remains high, the field life will be extended as unexploited resources become economic and commercial reserve estimates increase. As DD&A is an estimate, this will change in response to the strategic and operational decisions made by the business to best reflect the consumption of the benefits of the reserves.

Key messages from our survey group

Almost all companies used the unit-of-production method to deplete upstream oil and gas assets.

The basis of calculation of the underlying reserves in applying the unit-of-production method varied. The most common bases were proved and probable reserves, and proved developed reserves.

Most companies with midstream and downstream oil and gas assets depreciated them on a straight-line basis.

3. Decommissioning and environmental provisions



Oil and gas companies often are exposed to legal, contractual and / or constructive obligations to meet the costs of decommissioning and dismantling assets at the end of their production life, in addition to restoring the site. These costs are likely to be a significant item of expenditure for most oil and gas companies. Specific decommissioning activities can include the plugging and abandonment of wells; the dismantlement of wellheads, production and transportation activities; and the physical restoration of an area of activity to its original, or better than its original, condition.

Key messages from the survey group

Almost all companies recognised a provision for decommissioning, but none of the companies mentioned a separate provision for decommissioning in respect of midstream and downstream facilities.

Approximately a third of companies disclosed the rate used to discount future cash flows in determining the amount of the provision. Amongst those companies that did include disclosure, the basis of discount rate showed significant variation, making comparison difficult.

The general level of disclosure in respect of decommissioning and environmental provisions varied significantly.

4. Interests in joint ventures



Joint ventures are common arrangements in the oil and gas industry, and come in a variety of forms. Companies historically have used joint ventures as a means of sharing the risks and costs of exploration and production activities, and as a practical way of entering new countries and areas of operation.

Key messages from our survey group

The term “joint venture” is widely used as an all-encompassing operational expression to describe shared working arrangements between oil and gas companies. However, this does not mean that such arrangements are joint ventures for accounting purposes.

A lack of disclosure sometimes made it difficult to understand the nature of the company’s interests in joint ventures from an accounting point of view. There also appeared to be some confusion regarding the accounting difference between jointly controlled assets and jointly controlled operations.

Just over half of companies accounted for jointly controlled entities using the equity method, with the remainder applying proportionate consolidation.

5. Business combinations



As the price of oil and gas has continued to reach record highs, the level of corporate activity in the oil and gas industry remains strong and continues to accelerate. Transactions that were less attractive at lower oil prices have become more economic in the present climate, and further investment in less traditional sources of oil and gas, such as mineral sands and coal seam gas, are becoming more popular. Companies also are exploring new markets that may have previously been restricted due to foreign investment or ownership requirements, such as in Kazakhstan, China and India. Companies are using the profits that they are making from the higher oil and gas prices to fund expansion and new investments in companies, particularly those that have proven reserves, or in new exploration areas. Consequently, the accounting for acquisitions is a subject that is relevant for most oil and gas companies.

Key messages from our survey group

The most common fair value adjustments in respect of oil and gas activities were to oil and gas assets, and deferred tax balances.

Fair value adjustments to decommissioning provisions were not common.

It appeared that goodwill was recognised on less than half of the business combinations reported in the latest financial year; and only limited disclosure of the factors giving rise to goodwill was provided. In a number of cases it appeared that any excess value was allocated to oil and gas assets.

6. Farm-ins and farm-outs



A “farm-in” is the industry term commonly used to describe the investment process by which a company (“farmee”) purchases an interest in an exploration licence. In our experience, the consideration paid for a farm-in investment often takes the form of a commitment by the farmee to meet future exploration or development costs that otherwise would be met by the owner (“farmor”), and may also involve reimbursement to the farmor of a portion of the capital expenditure incurred to date.

Key messages from our survey group

Numerous examples of farm-ins and farm-outs were mentioned in the annual reports, but commonly were confined to sections of the annual report such as the chairman’s statement or the operating review. There was little information about farm-in and farm-out transactions within the financial statements.

7. Reserves reporting



Over the past five years there has been significant debate regarding reserves reporting, with further focus due to a number of well-publicised restatements of published proved reserves estimates. A significant part of the ongoing debate is focused on the U.S. requirements. The SEC's rules were introduced in 1978 and focus on "proved reserves," which are a small part of the total reserves controlled by companies. The definitions forming the basis of the SEC's rules were derived from definitions established by the Society of Petroleum Engineers.

One of the most important restrictions on published information that arises from the current SEC rules is the prohibition on allowing probable and possible reserves (or other even less certain estimates of reserves) to be reported in U.S. filings. Similarly, oil recoverable from oil-sands operations also must be excluded from disclosures about oil and gas producing activities. The SEC has to date considered oil-sands extraction to be a mining activity, although most companies describe oil-sand reserves separately. This is becoming increasingly significant as large oil-sands basins such as those in Canada are being developed.

Reporting requirements in other jurisdictions allow or even require broader measures of reserves and resources to be published. For example, Canada's NI 51-101 *Standards of Disclosure for Oil and Gas Activities* requires a statement of probable reserves and permits a statement of possible reserves.

In June 2008 the SEC published its *Proposed Rule on Modernization of the Oil and Gas Reserve Reporting Requirements*, which addresses many of the above concerns.

Key messages from our survey group

The reporting of oil and gas reserves was a common feature of the annual reports.

The most commonly used convention for measuring and presenting reserves estimates was proven and probable (also known as 2P) reserves.

A majority of companies disclosed their process for the preparation and / or audit of the reserves report.

A range of presentational styles and measurement methodologies was applied to reserves reporting, making comparisons between companies difficult.

8. Critical judgements and key sources of estimation uncertainty



Oil and gas companies make a number of key estimates and judgements that are industry-specific. One of the most important estimates, from both an operational and an accounting perspective, is the estimate of reserves (see section 7). Oil and gas companies rely on this measure to assist them in setting the strategic direction of the company as the reserve estimate drives the selection of which fields to develop, which to focus exploration activities on, and how long the field life is.

Another key estimate relates to the cost of decommissioning (see section 3). One of the assumptions that make this estimate so difficult to assess is the impact of future technological developments on the costs of decommissioning a site. In our experience, over the last 12 months any savings from the expectation that future costs will be reduced due to technological advances have been offset by the shortage of skilled labour and materials, resulting in increased cost estimates.

Key messages from our survey group

The most common areas of disclosure in respect of critical judgements and estimation uncertainty were reserves estimates, decommissioning liabilities, and the impairment testing of oil and gas assets.

9. Revenue



The increasing global price of oil and gas has meant that many oil and gas companies are focusing their operations on extracting reserves that may have been previously uneconomic. In our experience, companies also are looking to renegotiate production-sharing agreements to ensure that as much resource as possible is being extracted while the prices of oil and gas remain at record levels.

Companies also are focusing on the timing of operations, especially when contracts are denominated by reference to spot prices. Oil and gas companies want to ensure that they are obtaining the best price for their product, and this is made difficult by operational issues such as production having to be transported long distances or using third-party infrastructure that may absorb some, but not all, of the delivery risk.

Key messages from our survey group

While all companies disclosed an accounting policy for revenue, a varying range of detail was provided. Only a small number of companies explained the timing of the transfer of risks and rewards of ownership.

A majority of companies disclosed a detailed breakdown of revenue that went beyond the strict disclosure requirements of IAS 18 *Revenue*.

10. Taxation and other fiscal features



Oil and gas production is the most important industry in many resource-rich countries. Therefore it is inevitable that the fiscal regimes applying to oil companies have a high public profile, and are scrutinised closely by many interest groups. Governments are under pressure to show that, as the ultimate resource owners, the people of the producing country benefit appropriately from the exploitation of the country's natural resources, which often is carried out by international oil and gas companies.

The fiscal regime in a particular country, and importantly investing companies' views on the stability of that regime, critically affect investment decisions and the allocation of capital. Overall the government can receive more than 90 percent of the price ultimately charged to consumers for fuel, and the upstream sector often is subject to significantly higher taxes than tax charged on the profits of other businesses.

Key messages from our survey group

Just over half of companies disclosed information on the classification in the financial statements, as income tax or operating expense, of taxation and other fiscal features.

There appeared to be limited consistency in the classification of specific taxes on oil and gas production activities.

11. Derivatives and commodity price risk



Oil and gas activities typically are exposed mainly to commodity price risk, which was the focus of our survey. Other exposures include foreign exchange risk, and to a lesser extent interest rate risk. Derivatives are used frequently within the industry to manage these risks. Larger oil and gas companies often have an energy trading division through which risks are managed and energy trading conducted. However, in our experience, relatively few companies take arbitrage trading positions.

Key messages from our survey group

Most companies used derivatives in risk management activities.

For companies that disclosed a sensitivity analysis in respect of commodity price risk, a value at risk analysis was not the preferred disclosure.

All companies that disclosed a sensitivity analysis considered oil price to be a significant risk.

12. Functional and presentation currencies



An entity measures its assets, liabilities, equity, revenues and expenses in its functional currency, and all transactions in currencies other than the functional currency are foreign currency transactions. Each entity in a group has its own functional currency; there is no concept of a group-wide functional currency under IFRSs.

Functional currency is determined by reference to the primary economic environment in which an entity operates. Oil and gas prices are routinely denominated in U.S. dollars, while costs often are incurred in local currency. However, the influence on supply and demand from countries like Russia, China and India makes it increasingly complex to determine the key factors that are influencing the primary economic environment of an oil and gas company.

Key messages from our survey group

Outside of the currency of the country in which the group's parent was based, the U.S. dollar was the most influential currency in determining functional currency.

A majority of companies chose as their presentation currency the currency of the country in which the group's parent was based.

13. Segment reporting



Oil and gas companies typically have diverse operations, either from a geographic area or from an integrated business model perspective. Smaller exploration-focused companies typically will have fields in a range of geographic locations in order to spread operational risks and to enhance their chances of success. In contrast, larger companies tend to be more integrated and have exploration, as well as midstream and downstream operations. These companies may place less importance on the geographic location of their assets and operations, and more importance on the different lines of business or markets in which they operate.

Many oil and gas companies manage their operations by grouping together risks, based either on geography or the nature of operations. In our experience, oil and gas companies tend to disclose extensive information by either field or main revenue stream. This discussion, which may not be included in the financial statements, typically includes management's assessment of the risks specific to that location or business. The discussion might cover, for example, the complex system of land title and access to permits that operate in emerging markets, and the political environment and potential risks that arise from unrest in various countries.

Key messages from our survey group

The most common primary segment reporting format was business segments.

Most companies that presented geographical segments as the primary segment reporting format did not have multiple business segments.

Two companies had adopted IFRS 8 *Operating Segments* before its effective date of 1 January 2009.

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