VIEWPOINTS:

Applying IFRSs in the Oil and Gas Industry

COMMODITY PRICES AND IMPAIRMENT

JUNE 2015

Background

Oil and gas assets and goodwill are tested for impairment whenever indicators of impairment exist and at least annually in the case of goodwill.

In the oil and gas industry, a decline in commodity prices is one of the numerous factors to be considered when assessing indicators of potential impairment and when performing an impairment test.[1]

Management must use its judgment to assess whether an impairment indicator exists. If an impairment indicator is concluded to exist, IAS 36 *Impairment of Assets* requires the performance of an impairment test.

Issue

How do commodity prices factor into impairment assessments and the calculations of possible impairments?

1 Commodity prices are also relevant in determining whether the factors leading to an impairment have changed in the period and an assessment is required as to whether a previously recorded impairment should be reversed. While some of the analysis in this document may be relevant to such an issue, the assessment of reversals of impairment is complex and is not specifically addressed in this document.

Oil and Gas Industry Task Force on IFRSs

International Financial Reporting Standards (IFRSs) create 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 Explorers and Producers Association of Canada (EPAC) and the Chartered Professional Accountants of Canada (CPA Canada) 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 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 CAPP, EPAC, CPA Canada or the organizations represented by the task force members.

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EPAC THE EXPLORERS AND PRODUCERS ASSOCIATION OF CANADA

Viewpoints

Determining Indicators of Potential Impairment

In the oil and gas industry, a significant decline in expected future commodity prices is a common potential indicator of impairment. In determining the significance of the decline and whether such a decline is an indicator of impairment, judgment must be exercised in assessing a range of factors, including:

Duration

The duration of a decline in commodity prices would be considered in determining whether the decline is a potential indicator of impairment.

Short-Term

In some circumstances, objective evidence may exist that short-term market fluctuations are not indicators of impairment. To make this determination, among other things, price estimates by an independent qualified reserves evaluator and contract prices might provide relevant and objective information.

Long-Term

In other circumstances, downward price movements can assume more significance if objective evidence exists that such declines are expected to persist (or do persist) for longer periods. For instance, a decline in commodity prices anticipated to persist over an extended period of time may more likely be considered as an impairment indicator; however, such evidence would need to be assessed relative to the expected remaining life of the reservoir or field.

Phase of Activity

Fluctuations in commodity prices may affect oil and gas projects differently, depending on the current phase of activity. A decline in commodity prices may potentially affect a project in the exploration and evaluation (E&E) phase differently than a project in the production phase (depending on the underlying indicators of impairment).

A decline in the commodity price for a project should be carefully evaluated in relation to management's assessment of the project's recoverable amount and/or whether further activity would continue in the lower price environment (e.g., activity may be curtailed during a period of depressed commodity prices as financing may be difficult to obtain and/or exploration spending is decreased to retain cash).

For oil and gas projects in the production phase, a decline in the commodity prices would likely impact revenue and, as a result, may be more easily viewed as an indicator of impairment.[2]

2 This Viewpoint does not consider the impact of hedging arrangements. The existence of hedging arrangements may alter the analysis presented.

Among other things, it is important to consider how a change in commodity price impacts the assessment of reserve and resource pricing and long-term planning (e.g., future development costs, operating costs, production volume, reserve and resource cut-off volumes, availability and/or timing of financing) as these may or may not be affected by the change, with a resulting impact on the project's recoverable amount.

Other Factors

Changes in commodity prices may affect other internal and external factors, such as:

- forecasted growth rates
- projected volume
- projected sales prices, including differentials for quality
- cost of capital (including availability of financing)
- cost structures (e.g., higher-cost projects may have a lower recoverable value)
- timing of cash flows (e.g., lower demand for commodities may delay cash flows)
- future capital expenditures and exploration budgets
- operational activity (e.g., the decision to reduce or stop production until demand increases)
- foreign exchange rates (particularly in countries where the oil and gas sector is a large portion of the economy)[3]
- willingness and ability to hold assets long-term

This list is not exhaustive since changes in commodity prices may influence other factors as well. Consideration of how changes in commodity prices affect such factors may provide insight into the recoverability of the assets under analysis.

Calculating the Recoverable Amount

IAS 36 prescribes the procedures that a company applies to ensure that its assets are carried at no more than their recoverable amount, which is the higher of the amount to be recovered through use of the asset (i.e., referred to as value-in-use) and the amount to be recovered through sale of the asset (referred to as fair value less costs of disposal (FVLCD)).

FVLCD is the amount that a market participant would pay for the asset or cash generating unit, less the cost of disposal.

When a discounted cash flow valuation model is used to determine FVLCD, it is important to factor in all relevant market information (including transactions with similar characteristics).

Commodity price assumptions are a key valuation input that should be based on (or incorporate as much as possible) observable market data. In assessing and/or selecting an appropriate observable market input (e.g., the expected commodity price, commodity price differentials) it is important to consider the expected life of the oil and gas project.

3 Generally, the more dependent a country is on its domestic oil and gas industry, the stronger the correlation between that industry's commodity prices and the country's foreign exchange rate.

Because many oil and gas operations extend well beyond the time horizon of observable market data, it is generally necessary to extrapolate financial results and make certain assumptions to cover the remaining expected life of the property. Furthermore, in fair value recoverability tests, market participants may use price estimates by an independent qualified reserves evaluator rather than pricing in the forward markets. Ultimately, in FVLCD, the inputs should be adjusted to align with assumptions that would be used by a market participant.

Assumptions may incorporate market data related to the commodity, such as:

- current spot prices
- forward curves
- price estimates by an independent qualified reserves evaluator
- prices in physical contracts (that are not derivatives)
- other relevant views of supply and demand.

The above list is not exhaustive.

Disclosure

Under IAS 36, numerous impairment-related disclosures exist, including the need to explain the events and circumstances that led to the recognition of the impairment loss. Such explanations may include a discussion of commodity prices.

In addition, IAS 1 *Presentation of Financial Statements* requires the disclosure of any significant judgments made in the application of a company's accounting policies, as well as major sources of estimation uncertainty. Commodity price assumptions will often be a major source of measurement uncertainty requiring such disclosure.

The Oil and Gas Industry Task Force on IFRSs

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