OIL & GAS INDUSTRY IFRS OVERSIGHT COMMITTEE

January 30, 2008

Attention: Mr. Paul Cherry,
Chair, Accounting Standards Board
Canadian Institute of
Chartered Accountants
277 Wellington St. West
Toronto, Ontario M5V 3H2

Attention: Ms. Liz Hickey, Director of
Technical Activities
International Accounting
Standards Board
30 Cannon Street
London, UK ED4M 6XH

Dear Mr. Cherry and Ms. Hickey:

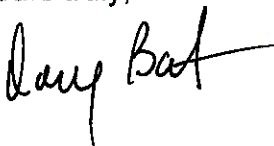
Re: Request for IFRS 1 Amendment

With the anticipated adoption of International Financial Reporting Standards ("IFRS") in Canada on January 1, 2011, the Oil & Gas Industry IFRS Oversight Committee ("Oversight Committee") was formed to develop consensus among key stakeholders; oversee industry documentation of credible and widely accepted guidance as to the application of IFRS accounting principles at adoption and thereafter; and within the Canadian oil and gas industry, to foster consistency and comparability in financial reporting.

Oversight Committee members represent both major industry associations – Canadian Association of Petroleum Producers ("CAPP") and the Small Explorers and Producers Association of Canada ("SEPAC") and the public accounting firms. Certain committee members have responsibility to maintain liaison with the Institute of Chartered Accountants of Alberta and the Canadian Institute of Chartered Accountants. The chief accountant of the Alberta Securities Commission also attends meetings of the Oversight Committee as an observer.

The Oversight Committee has reviewed the industry's submission requesting an amendment to IFRS 1 at the date of transition to IFRS in Canada. We wish to express our support for the submission and request your consideration and acceptance of the outlined recommendation.

Yours truly,



Doug Baker, FCA
Chairman, O&G Industry IFRS Oversight Committee
Vice-Chair, Canadian Institute of Chartered Accountants

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Ms. Liz Hickey
Director of Technical Activities
International Accounting Standards Board
30 Cannon Street
London, United Kingdom EC4M 6XH

Dear Mr. Cherry and Ms. Hickey:

Re: Request for IFRS 1 Amendment

The Canadian Association of Petroleum Producers (CAPP) represents 150 companies that explore for, develop and produce natural gas, natural gas liquids, crude oil, oil sands, and elemental sulphur throughout Canada. CAPP member companies produce more than 95 per cent of Canada's natural gas and crude oil. CAPP also has 130 associate members that provide a wide range of services that support the upstream crude oil and natural gas industry. Together, these members and associate members are an important part of a $100-billion-a-year national industry that affects the livelihoods of more than half a million Canadians.

The Small Explorers & Producers Association of Canada represents more than 400 emerging and junior oil and gas exploration and production companies. With a strong focus on exploration, the junior oil and gas sector raises billions of dollars each year from both Canadian and international sources to fund the capital investment needed to find and development new reserves of oil and gas in North America.

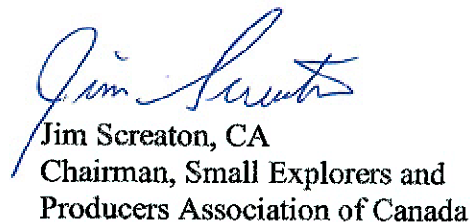
As you know Canada is expecting to adopt International Financial Reporting Standards as at January 1, 2011. In response, the Canadian oil and gas industry created a task group comprised of professionally qualified industry accountants to focus on identifying issues and, with the assistance of the public accounting firms, developing resolutions to each of the issues faced by our industry in the conversion and implementation of IFRS. In the course of activities to date, a key conversion issue has been identified which is the subject of this submission.

Virtually all of Canada's independent oil and gas exploration and production companies use the full cost method of accounting for their fixed assets. Conversion to IFRS, as currently published, would cause the Canadian oil and gas industry to enter into a very costly and, in many cases,

almost impossible process of recreating detailed historic records as at the transition date. Investors, bankers and other creditors already rely heavily on independently determined oil and natural gas reserve values rather than historic costs of fixed assets, so a costly conversion process would have little or no economic benefit to stakeholders.

Accordingly, the Canadian oil and gas industry respectfully recommends that IFRS 1 be amended to require the historic net book value of the fixed assets accounts be allocated at the IFRS transition date between exploration and evaluation assets and property, plant and equipment as outlined in more detail in the attached proposal. This proposal, prepared by the industry IFRS task group, is the result of analysis and comment by a broad cross-section of the Canadian oil and gas industry and the public accounting firms. Both of our industry associations support the proposal and request your thoughtful consideration and endorsement.

Yours truly,



Pierre Alvarez
President, Canadian Association
of Petroleum Producers

Jim Screaton, CA
Chairman, Small Explorers and
Producers Association of Canada

Attachment

The IFRS requirements for property, plant and equipment and exploration and evaluation costs cause significant transition issues for oil and natural gas ("O&G") exploration and production enterprises in Canada that use the full cost method of accounting. The purpose of this submission is to explain the industry's concern and to propose an amendment to IFRS 1 to address the issue.

Background

Capital Markets

Canada has one of the world's leading capital markets for O&G enterprises. As at October 31, 2007, the total market capitalization of the 410 O&G enterprises listed on Canada's two principal stock exchanges ("Issuers"), the Toronto Stock Exchange ("TSX") and the TSX Venture Exchange, was almost $CDN 550 billion. For the ten month period then ended, more than $CDN 260 billion of the equity from these Issuers was traded on these exchanges. These Issuers represent approximately 24% and 19%, of the total market capitalization and equity traded, respectively, on Canada's two principal stock exchanges. Worldwide, these Issuers represent about 50% of the total number of public O&G enterprises. Besides the share capital market, many Issuers also are active participants in the world-wide debt market, borrowing billions of dollars of publicly-traded and privately-sourced debt securities each year.

Approximately 401 Issuers follow the full cost method of accounting for O&G exploration and development activities. These 401 Issuers comprise approximately $CDN 240 billion of market capitalization as at October 31, 2007 and traded, during the 10 month period then ended, approximately $CDN 150 billion of value. In addition, there are over 500 private Canadian O&G full cost accounting enterprises which rely, to varying degrees, on the world's capital markets, and which will be affected by these changes in accounting standards.

A significant amount of this publicly traded equity capital is sourced from outside Canada. This demonstrates that the financial and reserves reporting regime for Canadian O&G enterprises is globally respected and key contributor to a fair, efficient and stable capital market for both senior and junior Issuers.

A small number of very large Canadian-based integrated and international exploration and production O&G enterprises follow the successful efforts method of accounting as promulgated by SFAS 19 -- *Financial Accounting and Reporting by Oil and Gas Producing Companies*. As this accounting method is conceptually more in compliance with current IFRS standards, the transition to IFRS is not anticipated to encounter the significant conversion issues faced by full cost accounting enterprises. Accordingly, this submission does not address any successful efforts conversion concerns.

Nature of Canadian Oil and Gas Industry

Canadian conventional reserves are located predominantly in the Western Canadian Sedimentary Basin ("WCSB"), and are characterized by high area density, low productivity wells drilled into small reservoirs. Based on industry statistics last updated to December 31, 2006, the WCSB had 201,000 wells producing an average of 25 barrels of oil equivalent per day per well. The industry

has drilled 22,000 wells per year on average over the last 5 years in the WCSB. In addition, many Issuers have participated in a significant number of transactions involving the buying and selling of assets and other corporations as part of their corporate development activities. While very similar to onshore O&G activities in the United States, the Canadian situation is very different from the O&G industry in the rest of the world because of small reserve pool sizes and related low production per well. In contrast, international O&G enterprises that have already adopted IFRS primarily operate highly productive wells drilled into large reservoirs, often in offshore locations. Since the Canadian O&G industry by its nature and absolute number of affected enterprises is very different from the international O&G industry, these differing circumstances warrant consideration of our proposal concerning transition to IFRS in Canada.

Disclosure of Oil and Gas Activities Outside Financial Statements

Canadian Securities Regulation includes National Instrument 51-101 – *Standards of Disclosure for Oil and Gas Activities ("NI 51-101")*. First coming into force on September 30, 2003, NI 51-101 is one of the most rigorous and comprehensive reserves reporting regimes in the world. NI 51-101 prescribes extensive standards for reserves and discounted cash flow measurement, disclosure, expert involvement and management certification. Investors, bankers and other creditors generally view NI 51-101 compliant disclosures as considerably more relevant than the fixed asset component of financial statements when making investment and credit extending decisions with respect to O&G enterprises.

Accounting Practices

Use of the full cost method of accounting for O&G activities is generally accepted in both Canada and the United States. Issuers in Canada generally follow CICA Handbook Accounting Guideline 16 – Oil and Gas Accounting Full Cost ("AcG-16") while those in the United States, representing a significant amount of publicly traded capital in their own right, follow a full cost accounting method outlined in SEC Regulation S-X. There are no substantial differences between Canadian and American full cost accounting principles other than for impairment testing.

AcG-16 and its full cost predecessor have been part of Canadian GAAP for over 20 years. The important feature of AcG-16 is that for purposes of depletion, depreciation and impairment testing, costs are accumulated in separate country-by-country pools. This basis of accounting has promoted financial statement consistency and comparability between Issuers, and is well understood and accepted by preparers, investors, regulators and auditors. Accommodation of our proposal would avoid a costly and likely problematic implementation, and retain the general acceptance and capital market goodwill so carefully built over the history of the Canadian industry.

Conversion to IFRS

Issuers that account for their O&G activities using AcG-16 understand the benefits of adopting a global set of accounting standard such as the International Financial Reporting Standards ("IFRS"). Moreover, upon adoption of IFRS in Canada, Issuers are willing to fully adopt all of IFRS in a principled manner. Issuers have been studying IFRSs 1 and 6, and IASs 16 and 36, and considering how to meaningfully comply with them. These studies have already spawned several working groups tasked with further understanding how IFRS will apply to several particular

Canadian O&G issues. Canada's Accounting Standards Oversight Council has also received a presentation from the O&G industry on initial IFRS adoption.

These efforts have identified that the retrospective accounting required of the fixed asset accounts to be a key conversion issue, which is the subject of the following proposal to you.

The Key Conversion Issue

Full Cost Accounting Under AcG-16

Issuers designed their accounting systems and fixed asset subledgers based on the accounting requirements of AcG-16 and the disclosure requirements of NI 51-101. Acquisition, development, exploration and seismic costs, tangible production assets and amounts allocated to exploration and development costs under the purchase method for business combinations have all been recorded in country-by-country cost centres, or pools. Subsequent depletion and depreciation (including amounts charged as impairments) are all determined and then recorded on this pool basis. Proceeds on disposition of properties are credited to the specific country pool unless the resulting disposition would alter the depletion rate for that country pool by more than 20%, in which case a gain or loss is recognized.

Once costs are added to each country pool, they are no longer identified with specific assets. For this reason, and because there are no income tax or other statutory requirements to record capitalized costs by property, enterprises have not been required to develop accounting records to track costs of individual assets. The only required segregation of costs within a country pool comprises those costs assigned to unproved properties for which proved reserves are not yet attributed and for which no evidence of impairment exists. These costs are segregated from costs subject to depletion and depreciation until such time as proved reserves are found or the prospects are found to be impaired, at which time the costs are added to other costs subject to depletion and depreciation. These segregated costs are disclosed in the notes to the financial statements, as required under AcG-16.

Restating Fixed Asset Accounts as at the IFRS Transition Date

IFRS 1 currently provides two alternative methods to O&G enterprises for transitioning to IFRS.

1. <u>Fair Value as Deemed Cost</u>

We understand that the fair value alternative is generally applied to specific assets not an entire class of assets with the significance of an enterprise's fixed asset accounts. Furthermore, as fair value information is not readily available, this option is not a practical alternative for the Canadian O&G industry. In order to implement the fair value option all assets, including reserves, production facilities and unproved properties, would need to be valued within the next 1 ½ years in order to have a compliant statement of financial position at January 1, 2010. Given the number of unproved properties, reserve pools and production facilities in western Canada and the lack of qualified independent valuators, establishing fair values for all these assets at a point in time would not be possible. In the absence of independent valuations, use of valuations determined by management would subsequently become a significant audit verification issue. We understand there is no current authoritative guidance to assist in determining fair values.

While IFRS allows the use of fair value in the transition opening statement of financial position, Issuers have a long-standing discipline of and predisposition for recording fixed assets using historic cost principles. Generally, historic cost provides a reliable basis for measuring returns on the initial investment. Historic cost information is broadly used to determine reserve finding costs and recycle ratios, which are commonly used by the investment community to rate the performance of Canadian O&G enterprises in the WCSB. There is widespread, almost unanimous, agreement within the industry that the alternative to use fair values as deemed cost for property, plant and equipment ("PP&E") in the opening IFRS statement of financial position would not be desirable.

Despite the acknowledged acceptance and reliance on securities regulation NI 51-101, use by some Issuers of estimated net present values from O&G reserves determinations under the "fair value as deemed cost" option, would cause a loss of consistency and comparability between financial statements within the industry. It is inconsistent to move all of an enterprise's fixed assets to fair value when the ongoing basis of measurement is historic cost. Moreover, Canadian O&G enterprises are more susceptible to wide fluctuations in commodity prices due to the significant amount of natural gas and heavy oil produced from the WCSB, which are both subject to seasonal commodity price swings. Use of fair values would negatively affect the comparability of Canadian and international O&G enterprises based on the dramatic increase in commodity prices since Europe transitioned to IFRS. For reporting periods following use of the fair value option on IFRS adoption, impairment write-downs and possible subsequent recoveries would be common given even modest changes in O&G commodity prices. Such volatility in the financial statements would reduce their clarity and usefulness to the reader.

2. <u>Restating Historic Cost Basis</u>

Restating the historic cost balances of PP&E and exploration and evaluation assets involves re-creating the fixed assets subledger reporting-period by reporting-period back to the commencement of operations, as if all of current IASs and IFRSs had been in place. Activities to re-create the accounting records would include:

- Allocating costs between items of PP&E and exploration and evaluation assets
- Defining cash generating units ("CGUs") for impairment testing purposes
- Expensing costs incurred prior to acquisition of legal title and capitalized general and administrative overheads
- Completing impairment assessments of historic exploration and evaluation assets for each past reporting period so as to move only recoverable costs to PP&E accounts
- Computing and recording gains or losses on dispositions of properties
- Re-computing and recording depletion and depreciation. As most Issuers use the unit-of-production method for both depletion and depreciation calculations, production and reserves information for each item of PP&E would need to be determined for each past period.

Completing all of the above activities to re-create the opening IFRS compliant statement of financial position would be very difficult, time-consuming and costly. The required historical data, including operating, capital and acquisition costs, and production and reserves information, would rarely be available at a sufficiently detailed level in order to make a reasonable allocation. Some, and possibly extensive, estimates and allocations of prior costs would be inevitable as the

detailed information to create certain subledgers is not accessible or no longer exists. Accordingly, allocations of prior sunk costs to fixed asset subledgers regardless of the allocation basis would then be inaccurate in the detail. Larger Issuers have substantial histories, hundreds of properties and projects, thousands of wells in the WCSB and many acquisition and disposition transactions. While smaller Issuers may have fewer exploration and development wells to re-examine, they have correspondingly fewer accounting resources to perform the accounting conversion. Even where the information might be available, the exercise is truly burdensome for an enterprise with any significant history or record of completing acquisitions. The cost to re-create the fixed assets subledger would significantly exceed its benefits to stakeholders.

Similarly, since O&G reserves reports were previously prepared to correspond to the full cost accounting records on a country basis, it is possible that previous reserve information does not contain enough detail to recalculate depletion and depreciation at the level required by IFRS. Issuers would likely require new O&G reserves reports to be prepared covering each historic period of operations to facilitate preparation of revised fixed asset accounts under IFRS. With the scarcity of both specific in-house expertise and external, independent evaluators required to prepare these O&G reserves reports, it would be costly, and in some cases not possible, to re-create the reserves of prior periods at a level of detail sufficient for IFRS.

Proposal

We propose that the International Accounting Standards Board ("Board") amend IFRS 1 to permit O&G enterprises to allocate, as at the date of the opening IFRS statement of financial position, their previously incurred historic costs to exploration and evaluation assets and to items of PP&E and the related CGUs they will use in their future IFRS financial statements. Such cost allocation would first allocate the historic cost, less any impairments, for unproved properties to exploration and evaluation assets. The remaining net book value would be allocated to items of PP&E on some systematic basis such as reserves volumes or their related estimated values. To ensure allocated amounts are not overstated, O&G enterprises would be required to test all CGUs for impairment at the date of transition. We understand that this is similar to the approach the Board adopted with respect to the insurance industry by requiring a contract liability adequacy test on transition for previously recognized insurance liabilities.

Because this proposal allocates existing historic costs to the opening transition statement of financial position, it indirectly results in the remaining capitalization of certain cost otherwise not eligible to be capitalized under IFRS, such as pre-legal title costs (to the extent such costs could not have otherwise been capitalized under IAS 38), capitalized overhead costs and unsuccessful project costs within the full cost fixed asset pool. As previously outlined, it may be extremely difficult or not possible to estimate the original costs of these components as at the IFRS transition date. However, impairment testing at the transition date would mitigate any potential overstatement of either exploration and evaluation assets or any PP&E CGUs.

We believe this transition relief could be provided with a relatively brief amendment of IFRS 1, either as part of the section dealing with deemed cost (paragraphs 16 to 19) or as an addition to paragraph 25. In addition, enterprises taking advantage of this option should be required to provide relevant disclosure of their approach to allocation and any amounts written off due to impairment testing or otherwise. Our proposed amendment to IFRS 1 might read as follows:

As at the date of transition to IFRS, an enterprise engaged in the oil and gas exploration and production industry may elect to allocate the historic net book value of its fixed asset accounts on the following basis:

- *to exploration and evaluation assets, based on historic costs related to unproved properties, net of any prior impairments;*
- *to items of property, plant and equipment, based on the remaining net book value of its previously capitalized property, plant and equipment accounts allocated on a pro rata basis using reserve volume information or their related values.*

The costs so allocated under this election will become the enterprise's deemed cost at the date of transition to IFRS.