CPAB exchange

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Industry Insights – *Oil and Gas*

Industry Insights

This publication is part of CPAB's *Industry Insights* series developed to support audit committees in their oversight role by enhancing the dialogue between the audit committee and the auditor.

Industry Insights – Oil and Gas discusses certain common areas of focus for an audit of a company operating in the oil and gas industry, with a focus on upstream activities. These areas may be considered together with the audit committee's knowledge of the industry and the company. An audit approach is a matter of professional judgment influenced by auditing standards, industry risks and specific characteristics of the company. This publication is not intended to prescribe an audit approach or the areas of focus in an audit.

Depending on the risks and materiality in the particular business, audit committees may choose to discuss the areas of focus and questions outlined below with their auditor (and management, where applicable).

Areas of Audit Focus

1. Economic Uncertainty

Going concern and debt covenants

Downturns in the energy commodity cycle place stress on the cash flows and balance sheets of many oil and gas companies. In a distressed industry, management is focused on ensuring the company remains a going concern and maintaining and responding to any violations of debt covenants.

In these circumstances, the audit strategy may include a focus on assessing management's evaluation of its future cash flows and analysis of the impact of current and expected economic circumstances on the future operation of the company. This may include an evaluation of management's current and forecasted calculations of debt covenants. An auditor's focus may also include evaluation of the classification of debt on the balance sheet between short term and long term, evaluation of the quality of any disclosures in the financial statements related to debt covenants and/or the company's going concern disclosures.

Internal controls

When faced with financial difficulty, some companies have responded to the current economic circumstances with staff reductions and decreased use of external consultants, including those in the finance and accounting functions.

In these cases, the auditor and the audit committee may find it important to understand the impact on internal controls over financial reporting. The quality of management's judgments and estimates in important complex areas such as impairment, recoverability of deferred taxes, unusual transactions, and going concern disclosures may be negatively affected by a deteriorating control environment.

Questions that Audit Committees may ask

i. How did current economic conditions change your identification and assessment of the risk of material misstatement? How was your audit approach impacted?
ii. Do management's forecasts of future cash flows incorporate reasonable assumptions in response to the current economic environment and near term outlook?
iii. How have the current economic conditions impacted the company's staffing and the operating effectiveness of the company's financial and operational controls?

2. Financial statement estimates (including those supported by oil and gas evaluation reports)

Management relies on internal and/or external management's experts to prepare evaluation reports on estimates of oil and gas reserves, resources other than reserves, and unproved properties not included in resource quantity estimates (oil and gas evaluation reports). These estimates are disclosed by companies in accordance with National Instrument 51-101, Standards of Disclosure for Oil and Gas Activities (NI 51-101). A qualified reserves evaluator or qualified reserve auditor (QRE) is required to prepare the estimates of reserves data, contingent and prospective resources data disclosed in its' NI 51-101 filing. Typically reporting issuers elect to set out the required information in its Annual Information Form (AIF). Valuation estimates of unproved properties other than those with an estimated resource quantity attributed may be prepared by a petroleum land management expert.

The assignment of reserves and the discounted cash flows developed in these resource evaluations support the technical feasibility and commercial viability of a resource as a company moves assets out of the exploration and evaluation phase to the development and production phases. Oil and gas evaluation reports are usually prepared as of the company's fiscal year end. They may need to be prepared or otherwise updated on an interim basis for financial reporting purposes (such as a valuation for a business combination). These evaluation reports provide the basis for a number of estimates in the financial statements including the:

1. Oil and gas reserve base used for depreciation and depletion calculations.
2. Fair value of oil and gas properties acquired in a business combination.
3. Recoverable amount for oil and gas property impairments and reversals and goodwill impairments. and
4. Timing of decommissioning obligations.

Management's judgment as to going concern disclosures may also be based on an estimate of short-term operating results provided by the oil and gas reserve estimate.

The auditor's procedures in considering financial statement estimates supported by the company's oil and gas evaluation reports may include:

- Assessment of the objectivity, competency and capabilities of experts (internal or external to the company) and their reliance for purposes of the audit.
- Testing of the operating effectiveness of internal controls over the development of the oil and gas evaluation reports including reviewing controls at various levels, for example up to a reserves committee of the board of directors.
- Assessment of the reasonability of significant judgments and assumptions made by management, such as those in respect of impairment indicators and reversals, future production quantities, commodity prices, operating and capital costs, royalty and tax rates, discount rates, etc.

The auditor may also respond by involving an auditor's expert to assist in the assessment of significant management estimates.

Questions that Audit Committees may ask

i. What did you do to assess the objectivity, competence and capabilities of management's experts?

ii. What was the form of your communication with the QRE? Did you obtain a reliance letter? How did you address significant risks and uncertainties, caveats or contingencies contained in the oil and gas evaluation reports?

iii. What were the significant assumptions, including those supporting fair value estimates, and how did you assess their appropriateness?

iv. Did you obtain a roll-forward analysis and perform procedures on oil and gas reserves/resources to understand the changes in the year? Were there any significant unexplained changes?

v. Were there any cash generating units where reasonable changes in assumptions could result in potential impairments?

vi. Describe how you identified the properties where you focused your audit procedures and audit work performed with respect to the oil and gas evaluation reports.

3. Classification of costs

Information regarding costs is one of the most important components of oil and gas key performance indicators (such as netbacks, cash and operating costs). In response to investor demand, oil and gas companies may go beyond GAAP measures and disclose non-GAAP margin or cost measures as important key performance indicators in their MD&A. Classification of costs may be an area of some judgment and it may be necessary for the company to have well documented accounting policies and procedures to assist its staff in appropriately classifying costs on a consistent basis.

In many cases, the GAAP presentation of costs as capital, inventory or operating costs is very important as the initial presentation forms the basis to derive non-GAAP measures. In performing the audit of the GAAP information, an auditor's audit plan is based on the assessment of risks of material misstatement in the costs presented in the financial statements due to fraud or error. In considering this area, the auditor may:

- Test the operating effectiveness of internal controls over cost presentations.
- Perform tests of details, including journal entry testing, or other substantive procedures to audit the allocation between capital and expense and cost classifications including presentation of items within the cash flow statement.

Questions that Audit Committees may ask

i. Does the company have well documented policies and procedures on capitalization or expensing as period or inventory costs and the allocation of costs within the income statement?
ii. What audit procedures were performed to ensure these policies were consistently followed?
iii. How did you audit the presentation of costs?
iv. Did you perform journal entry testing in response to any assessed risk that the company is inappropriately moving period costs to capital costs?

4. Auditing in foreign jurisdictions

Canadian oil and gas companies often have projects in foreign jurisdictions, some of which can create additional challenges for auditors and audit committees. In some cases, the firm engaged in the audit of the parent company (group auditor) may use the work performed by an auditor located in the foreign jurisdiction (commonly a foreign affiliate of the group auditor – also referred to as the component auditor).

Regardless of the level of involvement of component auditors, the group auditor is responsible for the overall audit strategy and audit plan, including effective supervision of the work performed by the component auditors. Audit plans need to respond to risks that are specific to entities in the foreign jurisdiction.

The auditor needs to have an awareness of the business practices, legal structures, customs and cultural norms in the foreign jurisdiction to identify risks and develop an appropriate audit strategy.

Questions that Audit Committees may ask

i. What components did you identify as having a higher risk? How was this addressed in your audit plan?
ii. How were the laws, regulations and business customs different in our significant components? What impact did these differences have on the audit approach?
iii. How were you involved in the supervision of the work performed by component auditors?

5. Income tax strategies

A company may adopt strategies to optimize taxation that involve complex arrangements across multiple jurisdictions, including intercompany financing arrangements. The types of taxes that a company is subject to, and the complexity of certain tax strategies, may require specialized knowledge. Management also determines the price for intercompany exchanges of goods and services (transfer pricing). A company may also be subject to uncertain tax positions including on-going audits by tax authorities and tax positions for which legislation is unclear, especially in foreign countries with less developed tax rules. Management applies judgment to determine the amount of any liability for such tax positions and must also consider updates to tax treaties, interpretations and court decisions relevant to clarifying legislation.

The audit team may involve tax specialists to evaluate the income, commodity or other tax consequences of certain transactions and to evaluate the accounting for complex tax strategies.

Questions that Audit Committees may ask

i. What procedures did you perform over the recoverability of deferred income tax assets?
ii. What tax strategies, including international finance structures, did you assess as having a greater risk of material misstatements and how were these tested?
iii. Have you reviewed the company's transfer pricing policies and do they seem appropriate?
iv. Are you aware of any significant tax disputes in foreign subsidiaries?

6. Decommissioning provisions

The existence and extent of decommissioning obligations is based on local legal obligations. A company may also have created constructive obligations for clean-up. Companies are usually obligated to provide funding or other surety and these amounts may significantly differ from the estimate of future costs. Companies and their auditors may rely on internal and external experts (such as lawyers and environmental specialists) to develop its estimates of future decommissioning and environmental remediation costs.

Questions that Audit Committees may ask

i. What procedures did you perform over the completeness of the provision for decommissioning liabilities?
ii. What significant factors and assumptions did you assess in the measurement of the liability, and how did you assess their appropriateness?

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