

GUIDANCE

Practice Guide to Auditing Oil and Gas Revenues and Financial Assurances for Site Remediation



CANADIAN AUDIT
& ACCOUNTABILITY
FOUNDATION



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Practice Guide to Auditing Oil and Gas Revenues and Financial Assurances for Site Remediation

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¹ Titles and organizations of individuals included in this publication were those in effect at the time of original publishing. The Canadian Audit & Accountability Foundation was then known as CCAF-FCVI Inc.

- **Daniel Mukuria**, Principal Auditor, Kenya National Audit Office
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- the leadership provided by CCAF-FCVI's President and CEO **John Reed**, Chair of the core project team;
- the contribution of CCAF-FCVI's Research Officer **Pierre Fréchette**², Lead Author for this project; and
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We hope this Practice Guide will be a useful and practical reference tool for audit professionals in Canada and abroad.



James A. Sylph, Chair, CCAF-FCVI Board of Directors



John Reed, President and CEO, CCAF-FCVI

² Comments, suggestions and new ideas can be provided to Pierre Fréchette at the Canadian Audit & Accountability Foundation (pfrechette@caaf-fcar.ca)

Table of Contents

Purpose of the Practice Guide	6
Part 1 Concepts and Context	7
Revenues from Oil and Gas Extraction	8
Royalties	9
Other Sources of Revenues	10
Revenue Framework: How Royalties and Fees Are Set and Collected	11
Financial Assurances for Site Remediation	13
Managing Liabilities for Site Remediation	13
The Life Cycle of Oil and Gas Projects	16
Phases of an Oil and Gas Project	16
Revenues from Phases of an Oil and Gas Project	17
Government Responsibilities in the Oil and Gas Sector	19
The Importance of Auditing Revenues and Financial Assurances	21
Mitigating the Risk of Fraud and Corruption	22
Published Audits on Oil and Gas Revenues and Financial Assurances for Site Remediation	24
Part 2 Audit Methodology	27
Introduction to Auditing the Oil and Gas Sector	28
Overview of Key Audit Steps	28
Determining the Audit Focus	31
Auditing Revenues from Oil and Gas Extraction	34
The Planning Phase	34
The Examination Phase	51
Auditing Financial Assurances for Site Remediation	57
The Planning Phase	57
The Examination Phase	71
The Reporting Phase	76
Setting the Context	76
Drafting Recommendations	82
References	83
Guidance and Good Practices	83
Performance Audits Cited in the Practice Guide	84
Other References on Revenues and Financial Assurances	86
Glossary	88

Purpose of the Practice Guide

The purpose of this Practice Guide is to provide contemporary guidance for public sector auditors on how to plan, carry out, and report on **performance audits** of oil and gas revenues and **financial assurances** for site remediation.

Little practical guidance is readily available on how to audit these two topics. This Practice Guide aims to fill this gap: it includes guidance for each phase of the performance audit process, as well as examples of questions to consider, audit objectives, and criteria.

Scope of the Practice Guide

This Practice Guide's focus is twofold: (1) auditing revenues from the extraction of oil and gas, and (2) auditing financial assurances for the **remediation** of oil and gas wells and associated facilities. It is strictly concerned with revenues from the upstream portion of the oil and gas industry, which includes activities in the exploration and production phases. It focuses on private sector extraction activities on public lands.

This Practice Guide does not cover:

- revenues from downstream activities, which include refining, distributing, and selling petroleum products and natural gas;
- revenues from general taxes, such as income and sales taxes;
- the operations of state-owned energy corporations; or
- the spending of **royalty** revenues by governments.

Using the Practice Guide

The Practice Guide is a flexible tool to be used within each audit office's existing processes and procedures, in accordance with auditing and assurance standards. It is therefore a complement to current audit methodology.

Readers do not have to read all the Practice Guide sections in order. Rather, the Guide has been designed to provide easy access to any section of interest and to allow readers to jump rapidly from one section to any other. Auditors are thus free to consult only the sections that best meet their needs.

[Back to Table of Contents](#)

Practice Guide to Auditing Oil and Gas Revenues and Financial Assurances for Site Remediation

Part 1 Concepts and Context

Revenues from Oil and Gas Extraction

Nations that have vast oil and gas reserves and that effectively oversee their development can derive many benefits from their extraction. Not only can extractive industries create numerous jobs and contribute significantly to economic growth, they can also be a significant source of revenues for governments. These revenues, in the form of royalties, lease payments, and other fees paid by private companies, can be spent to support government programs or to reduce public debt, or they can be saved for future generations.

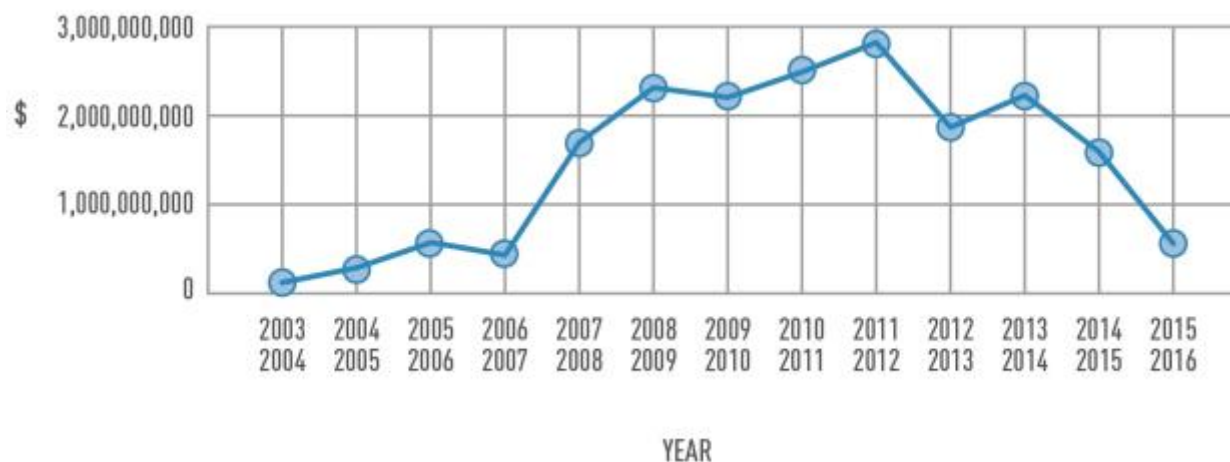
Depending on natural resource reserves, industry development, and market conditions, revenues from oil and gas extraction can make up a large portion of a national or regional economy. For example, in Newfoundland and Labrador, offshore oil royalties of \$1.7 billion³ represented approximately 27 percent of the province's revenues in the 2014–15 fiscal year. This proportion can be even higher in other resource-rich jurisdictions, such as Russia (50 percent), Nigeria (70 percent), or Saudi Arabia (90 percent).

However, government revenues from oil and gas extraction can vary greatly from one year to the next, depending on the state of the world's economy, energy demand, resource prices, exchange rates, the development of the industry in each region, and other factors. **Figure 1** illustrates this variation for Newfoundland and Labrador, where offshore oil royalties were only \$65 million in the 2002–03 fiscal year when the industry was still young, before multiplying 43 times to \$2.8 billion by the 2011–12 fiscal year as production increased, and finally falling to approximately \$550 million in 2015–16 as international oil prices plummeted. From a high of 39 percent in the 2012–13 fiscal year, offshore oil royalties were expected to represent less than 10 percent of the province's budget in 2016–17, forcing the government to make spending cuts and to seek new revenue sources to compensate for its lost royalty revenues.

Similar boom and bust cycles have been common in the history of the oil and gas sector and will continue in the future as production and demand change and markets adapt to new circumstances. Accordingly, governments have to consider this variation and uncertainty when they make decisions about how best to derive revenues from national or regional oil and gas reserves. Royalties and the other main types of revenues that governments can collect from oil and gas extraction are described next.

³ In this guide, all amounts are in Canadian dollars, unless otherwise noted.

Figure 1 – The Rise and Fall of Offshore Oil Revenues for the Government of Newfoundland and Labrador, 2003–2015



Source: Adapted from CBC News, 13 April 2016, *Royalty Bust Brings Pain to Newfoundland and Labrador*, with data from *Newfoundland and Labrador Public Accounts*. (Reproduced under CBC licensing)

Royalties

Royalties are the price that the owner of a natural resource charges a private company or consortium for the right to develop this resource.

Terminology

In practice, the use of the terms “taxes” and “royalties” can be confusing at times. Depending on the terminology and rules adopted in each jurisdiction, “production taxes” may be charged instead of royalties. For the sake of clarity and simplicity, this Practice Guide uses the term “royalties” to refer to all oil and gas revenues collected by a government in compensation for the extraction of publicly owned natural resources. The term “taxes” refers to general revenues that are collected from any kind of business, including income and sales taxes.

The right of governments to levy royalties from oil and gas companies derives from their ownership of natural resources. Through royalty payments, governments are compensated by oil and gas companies for the extraction of public natural resources.

In most jurisdictions around the world, governments own and manage resource development on behalf of their citizens. In Canada, for example, provinces own the natural resources found on public lands. (The exception is offshore oil and gas, which is a federal responsibility or, in the case of Nova Scotia and Newfoundland and Labrador, a joint federal-provincial responsibility. There may also be revenue-sharing agreements as part of land claim agreements with First Nations.) Provincial governments are therefore entitled to collect royalties from oil and gas companies. They can clarify this right through legislation, regulations and contracts.

Governments generally use one of two systems: (1) a concession system where regulated royalty rates apply to all producers equally; or (2) a system of **Production Sharing Agreements (PSAs)** with producers, where rules and rates may vary from contract to contract. In a PSA, a government collects an agreed share of profits from oil and gas production – some PSAs stipulate that royalty payments must also be made. This Practice Guide is more relevant for the audit of concession systems, but many of its sections may be useful for planning performance audits of PSAs (compliance audits are also common for PSAs).

Royalties apply once production has begun at a new site. There are different types of royalties, the main ones being:

- **Volume-based (or specific) royalties:** a regulated price per unit of production. This type of royalty requires **controls** to monitor production and to ensure there is no illegal (unrecorded) extraction.
- **Value-based (*ad valorem*) royalties:** based on the value of the extracted commodities. The value is volume multiplied by price (set by the market), so the difficulty of establishing price (which varies day to day) is added to the difficulty of establishing volume.
- **Profit-based royalties:** based on a company's profits. While this is in many ways similar to an income tax, it is an additional charge for the extraction of public natural resources. Like an income tax, this type of royalty requires government departments with strong financial, technical, and administrative capacity to regulate and collect the royalties while minimizing the risk of tax evasion. (**Transfer mispricing** is a common example of tax evasion in the natural resources sector) The challenge is substantial because many extractive companies are global market players that are not regulated by any single government.

Oil and gas companies pay royalties in addition to their regular income taxes. However, royalty payments are deductible for income tax purposes in many jurisdictions.

Other Sources of Revenues

In addition to royalties, governments can collect other revenues at different phases of the [life cycle of oil and gas projects](#).

Leases

During the exploration phase of an oil and gas project, it is usual for governments to require proponents to pay a set rate for the lease of each unit of land over which they intend to conduct exploration activities. Alternatively, governments can auction exploration rights over certain territories. In both cases, proponents pay to secure the exclusive rights to conduct exploration activities over a piece of land (or sea) for a determined period of time. Depending on the location and size of land (or sea) parcels, the type and market value of natural resources, and general economic circumstances, lease fees and auctions can generate significant revenues for governments.

Licence and permit fees

Through the successive phases of oil and gas projects, project proponents may be required by regulations to obtain a number of licences or permits to conduct specific exploration, production, or **decommissioning** activities (a well-drilling licence, for example). A fee may be charged for these licences and permits. However, these fees are usually small and often do not yield significant revenues for governments.

Bonuses

Bonuses are one-time payments made upon the signature of a contract, the launch of activities at a project site, or the achievement of certain goals laid out in regulations or in contracts. Being one-time payments, collecting bonuses does not require as much administrative capabilities as collecting royalties. Bonuses also do not generate as much revenues as royalties. Bonus payments are often negotiated on a case-by-case basis, taking into consideration the characteristics of each project.

Penalties and fines

Leases and licences grant certain rights to project proponents, but they also bestow obligations on them. For example, leaseholders may be required to carry out a minimum amount of work each year on a parcel of land or to hire a minimum number of workers. Penalties (or “cash in lieu”) may apply when these requirements are not met and leases may be rescinded under certain conditions. While such penalties will rarely yield significant revenues for governments, they should be set high enough to effectively deter undesirable behaviour.

Revenue Framework: How Royalties and Fees Are Set and Collected

Oil and gas reserves are publicly owned resources and governments are entitled to collect royalties or fees for their exploration and extraction. The challenge governments face is to design a **revenue framework** (a specific mix of revenue sources and their associated rules) that maximizes the benefits for society while still fostering continuing private capital investments, which are necessary to realize economic benefits over the long term. In some instances, governments may decide to set royalty rates below those in other jurisdictions in order to attract investments and boost economic diversification outside of urban centres. In the end, royalty rates and fees depend on a government’s specific socio-economic objectives.

In designing revenue frameworks for oil and gas extraction, governments must establish their fiscal objectives (such as revenue stability, revenue maximization, economic efficiency, and administrative efficiency) and make a number of key decisions about which revenues sources to adopt and how each one will operate. Different revenue frameworks will accomplish different goals and will fit different circumstances. For example, a strictly volume-based royalty regime will provide predictable revenues from the start of production at a new site, but will not allow a government to benefit fully from large price increases in energy markets. On the contrary, a profit-based royalty regime can allow governments to benefit from sharp price increases, but will not generate revenue until a company declares profits and will provide less revenue when resource prices are very low. Governments must carefully consider which regime (the volume-based and profit-based regimes are only two possibilities) will be more likely to achieve their fiscal objectives.

Governments must also ensure that their royalty regime and other fees are reviewed and updated from time to time, to ensure that the rates they charge for resource extraction are still:

- competitive compared with other jurisdictions;
- aligned with fiscal objectives;
- reasonable, considering factors that may affect profitability, including evolving extraction technologies and environmental requirements; and
- adapted to prevailing circumstances in the energy sector.

In addition, legislation and regulations need to be in place to provide a legal framework that allocates clear roles and responsibilities to government and private sector organizations. Controls and administrative capacity also need to be established to ensure the accuracy and completeness of royalty assessments and to manage the collection of royalties and other revenues. Government departments responsible for natural resources management are often responsible for collecting royalties from oil and gas extraction, although in some instances this responsibility is shared with a revenue agency.

The collection process often requires oil and gas companies to make monthly or quarterly payments to a government based on estimated production, sales, or profits. An annual **royalty return** is then filed at the end of each year. After processing and review, a final payment is made if there is a balance owing or a reimbursement is issued if too much has been paid by a company. While royalties are usually paid in cash, they can also be paid in kind. For example, an oil company gives barrels of oil to a government, which then sells this oil itself or uses it to fuel its own operations.

While this collection process may seem simple at first glance, it can be quite complex in practice.

- Royalty payments are required from the owners of each production site. In practice, a site can have many owners, each with a different share of the project. Royalties must then be paid in proportion to the ownership share.
- Royalties are often calculated after allowable expenses have been deducted. The rules about what is and what is not an allowable expense can be quite elaborate and, in many jurisdictions, expenses for one project can be used to lower royalties owed on another project.
- Royalties owed are assessed on the basis of information provided by private companies. To ascertain that they are receiving the correct amounts, governments must verify this information and conduct audits of production and expense data.

Finally, governments are responsible for ensuring that all oil and gas companies submit their royalty payments on time and for collecting penalties and interest as prescribed by regulations.

[Back to Table of Contents](#)

Financial Assurances for Site Remediation

The development and operation of an oil or gas field can take several decades. Over this time, exploration and extraction activities can significantly change local ecosystems. Vegetation cover will often be removed, local drainage patterns can change, species diversity may be reduced, and soils and waters may be contaminated.

Nowadays, at the end of an oil and gas project, the proponents are usually required by regulations to return operation sites to their natural state or to a state that meets established standards. However, years ago, before such regulations existed, many sites were abandoned once operations ceased and were not rehabilitated. In many cases, governments inherited the responsibility for cleaning up these sites and for the costs of doing so.

Governments can also remain responsible for the ongoing maintenance, monitoring, and management of certain sites over long periods.

The costs of remediating and maintaining decommissioned oil and gas wells and associated facilities can be very important. In 2012, for example, it was estimated that overall future **environmental liabilities** (clean-up costs) for Saskatchewan's 87,000 oil and gas wells and 5,300 facilities could total \$3.6 billion. Should licensees fail to clean up their wells and facilities, the clean-up costs could fall on the province's taxpayers.

In addition, liabilities may increase over time due to more stringent environmental standards. In such an instance, lands that had previously been remediated to existing standards may require additional remediation work if they do not meet new standards. The question of who is responsible for these new liabilities may be difficult to resolve. Ultimately, governments may have to assume partial or full responsibility for these costs.

Managing Liabilities for Site Remediation

To prevent governments from becoming responsible for the remediation of oil and gas wells and facilities and to reduce the financial burden on taxpayers, many governments have taken measures to ensure that leaseholders fulfill their responsibilities for decommissioning and remediating their oil and gas production sites.

Some governments have set up remediation funds to which oil and gas companies must regularly contribute. These funds are used to remediate legacy sites as well as any new abandoned site (as the result of a company going bankrupt, for example).

Other governments require private companies to provide sufficient financial assurances (such as securities and bonds, letters of credit, certificates of deposit, and cash) to guarantee that there will be enough resources to remediate their active sites once operations cease. These financial assurances are only released once a government is satisfied that a site has been remediated as expected. This is the approach taken in British Columbia, for example, where every well operator has been required since 2004 to submit a security deposit under the *Petroleum and Natural Gas General Regulation*. A generic financial assurance process is described in **Figure 2**.

Figure 2 – The Main Steps of the Financial Assurance Process Over the Life of an Oil and Gas Extraction Site



The main difference between remediation funds and financial assurances is that a fund can be used to clean up any decommissioned oil and gas site, whereas a financial assurance provided by a company can only be used to clean up a particular site leased by that company if it cannot meet its remediation responsibilities. Another difference is that financial assurances are returned to companies once they have met their remediation obligations, whereas fund contributions are not refundable.

While financial assurances do not provide a revenue stream, they do mitigate the risk of governments inheriting financial liabilities for sites abandoned by private companies. By establishing financial assurances requirements, governments can protect taxpayers from new liabilities for site remediation.

The effectiveness of remediation funds and of financial assurance programs depends on a number of design and implementation factors. The funds or programs must be based on adequate risk assessments and on reliable estimates of remediation costs. They must also be well-adapted to each natural resource sector (for example, traditional oil and gas wells, “fracking” wells, oil sands, and offshore wells).

Sufficient resources must also be made available to:

- collect financial assurances,
- assess the adequacy and completeness of remediation plans submitted by private companies,
- monitor progress on remediation work,
- attest that remediated sites have met all applicable standards and requirements, and
- regularly update estimates of future remediation costs.

[Back to Table of Contents](#)

The Life Cycle of Oil and Gas Projects

The oil and gas industry is a major sector of the economy in Canada and in many other countries around the world. Oil and gas extraction projects are usually capital-intensive, long-term, and potentially very lucrative. The revenues they generate are significant for both private companies and governments. However, not all oil and gas extraction projects come to fruition and, when they do, it is only after many years of planning, exploration, and development activities.

Phases of an Oil and Gas Project

The typical life cycle of an oil and gas project includes five phases:

1. exploration,
2. appraisal,
3. development,
4. production, and
5. decommissioning.

An overview of this life cycle is presented in **Figure 3**.

Figure 3 – Typical Life Cycle of an Oil and Gas Extraction Project (from an industry perspective)



Revenues from Phases of an Oil and Gas Project

In terms of government revenue, there are significant differences between the pre-production (exploration, appraisal, and development), production, and decommissioning phases.

The pre-production phases

Revenues from the pre-production phases come from the lease and licensing fees paid by the oil and gas companies for the right to conduct exploration and development activities in specific areas, on land or at sea. These revenues vary by jurisdiction based on how licences are allocated (whether through auctions or an application process), the resource potential of each region, and general economic circumstances.

Revenues may also be derived from penalties (or “cash in lieu”) imposed on leaseholders when they fail to comply with regulations that require them to carry a minimum amount of exploration work every year on their allocated lands. These penalties are relatively small for each hectare or acre of land, but can add up if the lease covers large territories.

The production phase

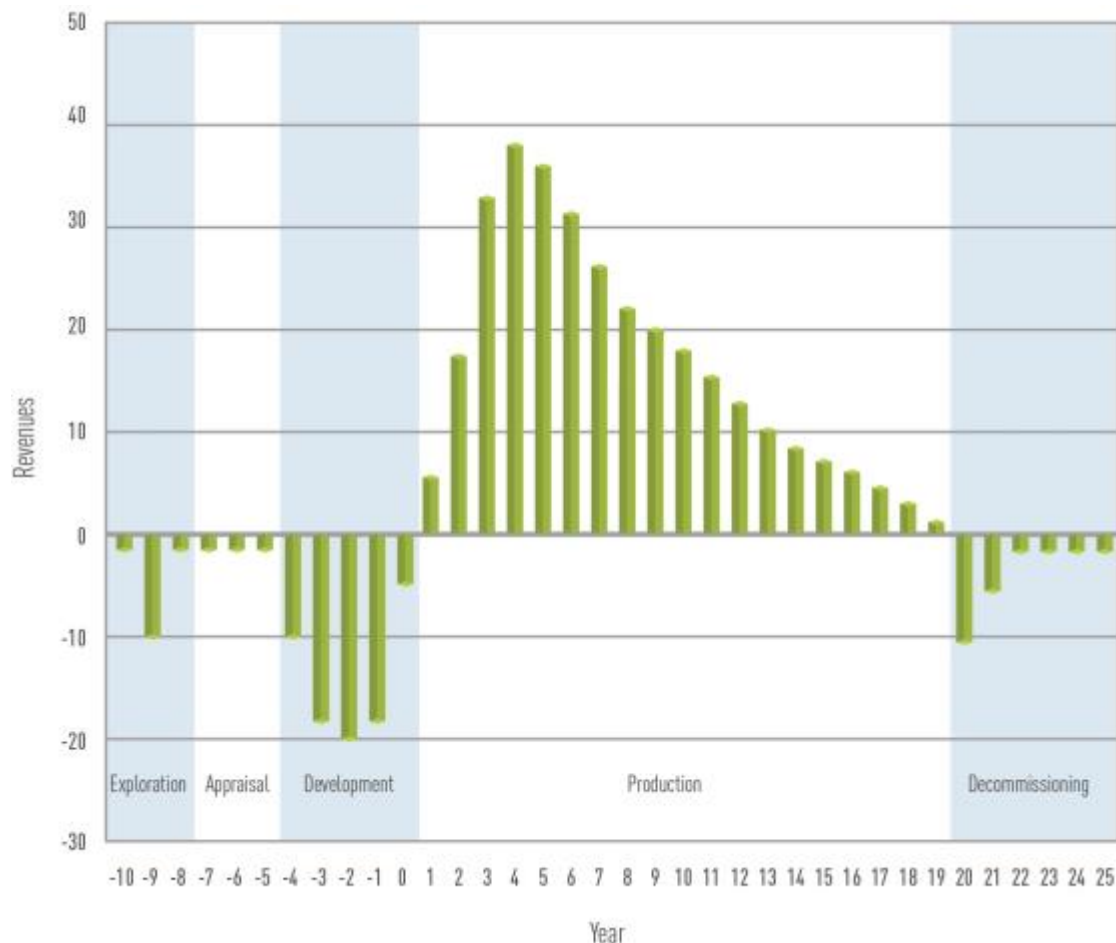
It is during the production phase that leaseholders can finally realize a profit on their investment. It is also during this phase that governments can receive large sums of money through royalty payments. The general trends in leaseholder’s revenues and expenditures over the life cycle of a typical oil and gas project are presented in **Figure 4**.

The production period usually lasts from 10 to 30 years from first oil to abandonment, but can be as long as 50 years for the largest fields. Over that time, production may vary depending on available reserves, the number of active wells, market prices, and other factors.

The decommissioning phase

When an oil well or a gas well is no longer profitable or productive, it needs to be decommissioned. Closing a site involves plugging the well, removing all structures and equipment, and returning the site to its natural condition or to a condition that meets regulatory standards. Soil decontamination may be required and, in some circumstances, ongoing monitoring and site maintenance may be needed over many years or in perpetuity.

Figure 4 – Leaseholder Revenues and Expenditures over the Life Cycle of a Typical Oil and Gas Extraction Project (from an industry perspective)



Source: Modified from F. Aliyeva (2011), [Introduction to the Oil & Gas Industry](#).

Decommissioning oil and gas wells is a significant expenditure for leaseholders. It is also a significant risk for governments. Should a company not meet its obligation to remediate a site, government could inherit responsibility for new, unfunded liabilities arising from the abandoned site. This has happened in the past and there are now thousands of abandoned wells across oil-producing areas in Canada, the United States of America, and many other countries. To prevent this situation from happening again, many governments have put laws and regulations in place to mandate mechanisms, such as financial assurances and remediation funds, that are expected to minimize the risk that taxpayers will become liable for the remediation of more abandoned sites.

The decommissioning phase is therefore not a revenue-generating phase for governments, but rather a liability-management phase. As such, it differs from the exploration and production phases. For this reason, the Audit Methodology part of this Practice Guide is divided in two main areas. The first area is concerned with [revenues](#) derived from the exploration and production phases, while the second is focused on the [financial assurance](#) systems that governments have put in place to manage liabilities for the remediation of oil and gas extraction sites.

Government Responsibilities in the Oil and Gas Sector

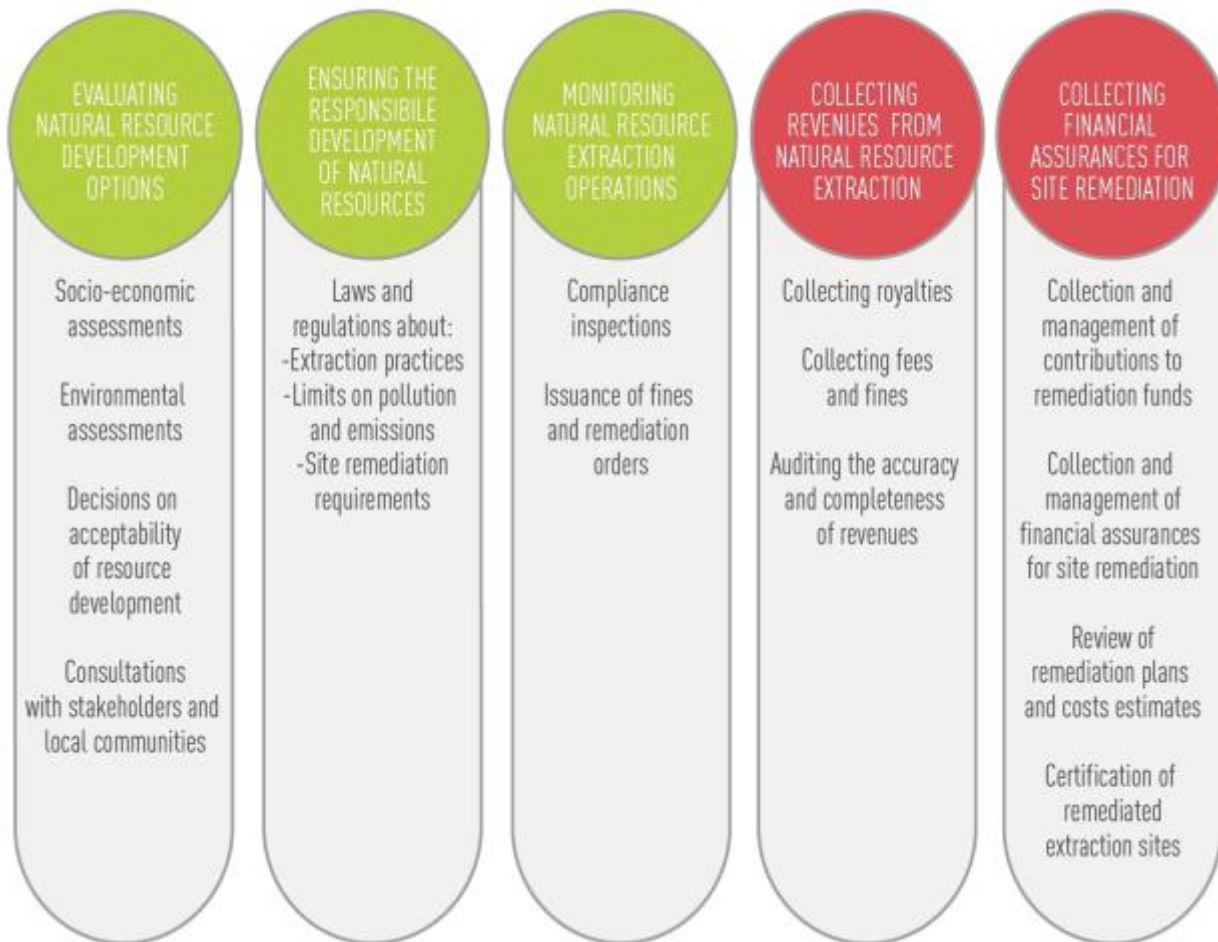
To be able to make sound scoping decisions for a performance audit of the oil and gas sector, auditors need to clearly understand the diversity and extent of government responsibilities in overseeing the sector.

These responsibilities can be separated into five categories:

- 1. Evaluating oil and gas development options:** This involves processes that help governments to make policy decisions on whether to develop a particular sector or not (for example, allowing natural gas extraction through “fracking” technology or the building of new pipelines), including environmental impact assessments, socio-economic impact assessments, strategic environmental assessments, and cumulative impact assessments. This process may also include, where relevant, the consideration of Aboriginal land claims and their impact on proposed developments.
- 2. Ensuring the responsible development of natural resources:** This involves putting in place laws and regulations that will set clear requirements that must be met by oil and gas companies to limit the impacts of oil and gas extraction on the environment and local communities. For example, regulations may prohibit certain extraction practices, set site remediation standards, or establish limits on the release of contaminants in the air, soil, and water.
- 3. Monitoring natural resource extraction:** This involves **oversight** activities carried out by government departments and agencies to ensure that oil and gas companies are in compliance with all applicable laws and regulations. This involves, among other tasks, conducting compliance inspections, issuing fines and remediation orders when necessary, and certifying that decommissioned extraction sites have been properly remediated.
- 4. Collecting revenues from natural resource extraction:** This involves setting rates and collecting all fees, leases, bonuses, penalties, and royalties related to the extraction of oil and gas, and conducting audits to ensure that all due payments have been received in full.
- 5. Collecting financial assurances for site remediation and monitoring financial liabilities:** This involves collecting financial assurances from leaseholders, assessing the adequacy and completeness of remediation plans submitted by private companies, monitoring progress on remediation work, attesting that remediated sites have met all applicable standards and requirements, and regularly updating estimates of future remediation costs.

These responsibilities are summarized in **Figure 5**. The topics listed in the last two columns of the diagram are covered in detail in this Practice Guide.

Figure 5 – A Government’s Responsibilities in the Oil and Gas Sector



[Back to Table of Contents](#)

The Importance of Auditing Revenues and Financial Assurances

The revenues that governments derive from natural resources are significant and are used to finance valuable social programs, services, and infrastructure. When governments are not collecting all revenues they are entitled to, their ability to pay for existing programs, to repay debts, and to create new initiatives may be diminished. Financial and performance auditors can play a key role in ensuring governments receive all the revenues from their natural resources they are entitled to.

There are many situations that can result in a government not receiving all the revenues it should from oil and gas extraction. For example, this can happen in the following situations:

- The right to operate is granted to companies that are financially unstable (higher risk of unfunded liabilities for site remediation).
- The list of operating companies has not been updated and is incomplete (risk of unreported extraction).
- Companies' declarations of production volumes are understated.
- Companies' declarations of production value are understated.
- Claims for allowable expenditures (which reduce amounts payable) are overstated.
- Producers use tax avoidance practices to reduce amounts otherwise owed to governments.
- Companies resort to fraud or corruption of officials.
- Unclear or misunderstood legislation and regulations result in incomplete payments.
- Audits of royalty payments are not completed within the time allowed by regulation, making adjustments to royalty payments and additional revenue collection impossible.
- Royalty rates are out of date and do not reflect changing market values of extracted resources or changing government policy objectives.

To ensure that they receive all the oil and gas revenues they are entitled to, governments need to establish clear rules for industry and put in place controls to ensure that the rules are being followed. These controls are of particular importance in the natural resource sector because governments tend to rely heavily on data provided by industry to determine what sums are to be paid for the extraction of public resources. For this reason, the [Audit Methodology](#) part of this Practice Guide places emphasis on the audit of controls.

Controls are also useful to protect government from liabilities associated with the remediation of decommissioned oil and gas wells. For example, governments can take the following steps to reduce their exposure to future liabilities:

- Establish documented standards on how site remediation cost estimates should be conducted.
- Have access to sufficient expertise to review cost estimates provided by operating companies.
- Periodically visit operational sites and update remediation cost estimates in accordance with current circumstances (such as site condition, operational plans, new technologies, and new regulatory requirements).

By auditing the management of financial assurances for site remediation, performance auditors can help governments to better protect taxpayers against future environmental liabilities.

Through their annual audits of natural resource revenues and financial assurances, financial auditors also play an important role. Performance auditors can leverage this work to develop their knowledge of business and identify risk areas, gaining insight from the prior analysis performed by financial auditors. Collaboration between performance and financial auditors can lead to more efficient and better-targeted audits.

In many audit offices, the auditors conducting performance audits will have a financial audit background and may be the same auditors that conduct the annual audits. However, in other offices, performance auditors will have more diversified backgrounds. In such circumstances, it can be beneficial for an office to create an oil and gas group where financial and performance auditors will regularly meet and share their knowledge and experiences with each other.

The INTOSAI Working Group on the Audit of Extractive Industries

In recent years, the INTOSAI (International Organization of Supreme Audit Institutions) community has paid increasing attention to audits of extractive industries. This interest has led to the creation of a Working Group on Audit of Extractive Industries (WGEI), which held its first meeting in Kampala, Uganda, in 2014. The WGEI aims to provide a range of capacity building and networking activities within and beyond the INTOSAI community. For more information on the Working Group and its activities, visit <http://www.wgei.org/>.

Mitigating the Risk of Fraud and Corruption

Fraud and **corruption** in the oil and gas sector can vary widely in scope and can involve officials with varying levels of authority. Some frauds are minor, perpetrated by public servants influenced by bribes or other benefits, while others are massive, as when high-ranking officials in resource-rich countries funnel royalty payments to their personal bank accounts in tax havens. Frauds can take place in jurisdictions where controls are minimal, but they can also take place in jurisdictions that have a well-developed regulatory environment. There is always a risk of fraud and corruption and this risk is higher when there is a strong reliance on data self-reported by the industry and much room for judgment and discretion in the application of existing regulatory processes.

Performance auditors can play a role in the worldwide fight against fraud and corruption in the natural resources sector. While the mandate of audit institutions regarding fraud and corruption may often be limited, performance auditors may detect instances of fraud and report these to the appropriate authorities. Furthermore, performance auditors can design their audits of public sector entities to include the examination of controls in place to prevent and detect fraud and corruption.

In this Practice Guide, commonly accepted definitions of fraud and corruption are used:

Fraud: An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Corruption: An abuse of public power, authority, trust, and resources for private or political gain. Corruption happens through the offering, giving, receiving, or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another party.

When it comes to fraud and corruption, the management of natural resources, including oil and gas, is a high-risk sector. This is mainly because of three factors:

1. The very large revenues that can be derived from natural resources by governments can provide significant financial rewards for individuals and companies that commit fraud.
2. In many countries, there is limited information available to the public about natural resource revenues. This limits oversight opportunities and reduces the likelihood that frauds will be detected.
3. Governments often have exclusive control of this sector and put in place a complex regulatory environment that allows for significant professional judgment in evaluating compliance. Because officials often have much discretion in applying regulations, there are many opportunities for abuse.

There are indeed many opportunities for fraud and corruption in the management of natural resources. The allocation of exploration and exploitation rights, for example, gives rise to opportunities such as the bribing of officials to rig bidding processes or to allocate rights without following due process. Similarly, the production phase, during which much revenues are generated, can lead to various abuses, including illegal extraction (operating without a licence), underreporting of production, tax evasion, invoice kickbacks, and bribing officials to turn a blind eye on instances of non-compliance, to name a few.

Additional Guidance on Addressing Fraud and Corruption

The United Nations counts fraud and corruption among the most serious challenges faced by the world community today. In recent years, the importance of fraud and corruption in the natural resource sector has been highlighted by the INTOSAI's Working Group on Environmental Auditing, which published a guide on this topic in 2013: [*Addressing Fraud and Corruption Issues when Auditing Environmental and Natural Resource Management: Guidance for Supreme Audit Institutions*](#).

Overall, fraud and corruption in the natural resource sector deprives governments all around the world of significant revenues every year, especially in developing countries with weak institutions and little oversight. To explain this situation, it has been argued that a lack of reliable public information about the flow of revenues to governments from extractive companies makes it impossible to monitor such funds and guard against fraud and corruption.

Based on this argument, international groups (for example, the [Publish What You Pay coalition](#)) and initiatives (for example, the [Extractive Industries Transparency Initiative](#), which is a global standard to promote the open and accountable management of natural resources) have been created to encourage governments to increase transparency about the payments they receive from natural resource extraction companies. Because of these initiatives, many governments have now enacted legislation that requires greater transparency or have committed to adopt such laws. For example, in 2014, Canada adopted the [Extractive Sector Transparency Measures Act](#).

Published Audits on Oil and Gas Revenues and Financial Assurances for Site Remediation

Performance auditors in Canada, the United States, Australia, and other resource-rich countries already have some experience auditing revenues from oil and gas extraction and financial assurances for site remediation. A search of our [Audit News database](#) and of other websites has identified more than a dozen performance audits on these topics published since 2008. **Table 1** presents a list of audits that examined oil and gas revenues, while **Table 2** provides a list of audits that examined financial assurances.

The focus of these audits varies considerably. Some have focused solely on royalties (for example, the [2008 Newfoundland and Labrador audit on offshore oil royalties](#)) or on financial assurances for site remediation (for example, the [2012 Saskatchewan audit on managing the risks and cleanup of oil and gas wells](#)), while others have covered one of these issues as part of a larger audit of the sustainable development of a resource sector (for example, the 2011 [Québec audit on the management of exploration and production activities in the shale gas industry](#)). These audits reflect the range of scoping options available to performance auditors when auditing the oil and gas sector.

Reviewing previously published audits in the early planning phase of a new audit may help audit teams to:

- complete their list of potential audit issues to examine and
- identify risk factors that they might not yet have considered.

Table 1 – Published Performance Audits on Revenues from Oil and Gas Extraction

Audit Office	Year	Title
Office of the Auditor General of Manitoba	2008	Compliance with Oil and Gas Legislation
Office of the Auditor General of Newfoundland and Labrador	2008	Oil Royalties
Government Accountability Office – United States of America	2008	Oil & Gas Royalties – The Federal System for Collecting Oil and Gas Revenues Needs Comprehensive Reassessment
Australian National Audit Office	2009	Administration of the Petroleum Resource Rent Tax
Vérificateur général du Québec (Office of the Auditor General of Québec)	2011	Gestion gouvernementale de l'exploration et de l'exploitation des gaz de schiste (government management of shale gas exploration and production)
Office of the Auditor General of Newfoundland and Labrador	2013	Oil Royalty Monitoring
Natural Resources Canada	2014	Audit of Offshore Revenues and Transfers
National Audit Office of Estonia	2014	Actions of the State in Directing the Use of Oil Shale
Federal Court of Accounts of Brazil	2014	Coordinated Audit About the Oversight of the Public Revenues From the Oil and Natural Gas Exploration and Production in Brazil, Colombia, and Peru
Government Accountability Office – United States of America	2015	Oil and Gas Resources – Interior's Production Verification Efforts and Royalty Data Have Improved, but Further Actions Needed
Office of the Auditor General of Alberta	2016	Energy – Systems to Manage Royalty Reduction Programs

Source: Data from our [Audit News database](#) and other sites for the period 2008–2016

Table 2 – Published Performance Audits on Financial Assurances for Oil and Gas Production Site Remediation

Audit Office	Year	Title
Office of the Auditor General of British Columbia	2010	Oil and Gas Site Contamination Risks: Improved Oversight Needed
Government Accountability Office – United States of America	2010	Oil and Gas Bonds – Bonding Requirements and BLM Expenditures to Reclaim Orphaned Wells
Government Accountability Office – United States of America	2011	Oil and Gas Bonds – BLM Needs a Comprehensive Strategy to Better Manage Potential Oil and Gas Well Liability
Vérificateur général du Québec (Office of the Auditor General of Québec)	2011	Gestion gouvernementale de l'exploration et de l'exploitation des gaz de schiste (government management of shale gas exploration and production)
Office of the Provincial Auditor of Saskatchewan	2012	Managing the Risks and Cleanup of Oil and Gas Wells
Office of the Auditor General of Canada (Commissioner of the Environment and Sustainable Development)	2012	Financial Assurances for Environmental Risks
Government Accountability Office – United States of America	2015	Offshore Oil and Gas Resources – Actions Needed to Better Protect Against Billions of Dollars in Federal Exposure to Decommissioning Liabilities

Source: Data from our [Audit News database](#) for the period 2008–2016

[Back to Table of Contents](#)

Practice Guide to Auditing Oil and Gas Revenues and Financial Assurances for Site Remediation

Part 2 Audit Methodology

Introduction to Auditing the Oil and Gas Sector

Performance audits of extractive industries, including the oil and gas sector, follow the same standards and general process as all performance audits. Auditors are required to follow the standards and audit processes applicable to their body of practice and office mandate.

An overview of the generic performance audit process is presented in **Figure 6**.

Figure 6 – Overview of the Performance Audit Process



Overview of Key Audit Steps

This introduction provides a brief overview of key audit steps that auditors must complete when undertaking an audit of the oil and gas sector. Many of these steps are discussed in more details in the following sections of the Practice Guide.

Audit Selection

In this Practice Guide, selection of audit topics is considered part of the overall performance audit process. Often, audit topic selection is done as part of an office's strategic planning process. Strategic planning is usually led by senior executives and is informed by an audit office's knowledge of business about its "audit universe" and analyses of materiality, **significance**, risks, and known problems. Other important considerations include the audit office's mandate, the availability of skilled auditors and resources, and the **auditability** of potential audit topics. The audit selection process normally results in a list of planned audits to be carried out over time.

There are many compelling reasons why audit offices would include audits of the oil and gas sector in their long-term plans, from concerns about environmental impacts to the significant economic role that this sector plays in many jurisdictions. For the purpose of this part of the Practice Guide, it is assumed that an executive decision has been made to audit the oil and gas sector and to proceed with audit planning.

Determining the Audit Focus

As shown in **Figure 6**, after an audit topic has been selected, the planning phase begins. This phase involves acquiring knowledge of business, assessing risks, and conducting analysis in order to determine the audit focus and set the stage to prepare a detailed audit plan that will include the audit objective(s), criteria, evidence collection methods, and analytical techniques.

The first step in this audit planning process is to determine what exactly should be audited in the oil and gas sector (that is, the audit focus). To make this decision, auditors will need to undertake two initial research and analysis tasks.

- Acquire knowledge of business by gathering and analyzing relevant information on the oil and gas sector and on [government responsibilities](#) in regulating, monitoring, and overseeing the sector.
- Identify and assess risk factors that could prevent the government from carrying out its responsibilities in this sector effectively and meeting its objectives.

At this stage, auditors can also review [audits on the oil and gas sector](#) that have been previously published by their office or other jurisdictions. This may help audit teams to complete their list of potential issues to examine and to identify risk factors that they might not yet have considered.

While there are a number of potential audit issues to examine in the oil and gas sector, the remainder of the Audit Methodology part of the Practice Guide focuses on auditing [revenues from oil and gas extraction](#) and [financial assurances for site remediation](#).

Detailed Audit Planning

Once it is decided that the audit will examine revenues from oil and gas extraction or financial assurances for site remediation, auditors can begin detailed planning work to further define their audit focus and audit procedures.

Detailed planning involves deciding which programs and controls to audit. To make these decisions, auditors will need to complete two tasks.

- Acquire further knowledge of business, by gathering and analyzing relevant information on the different types of revenues or financial assurances that the government is collecting and managing, and on the systems and practices it uses to do so.
- Identify and assess risk factors that could prevent the government from collecting all the revenues it is entitled to or all the financial assurances it needs to ensure that decommissioned oil and gas production sites will be properly remediated.

Equipped with the required information, audit teams will be able to determine which revenue or financial assurance programs and controls to audit. Once these decisions are made, auditors will be in a position to:

- draft their audit objectives,
- select their audit criteria, and
- prepare plans with detailed audit procedures.

All these steps are covered in more detail in this part of the Practice Guide. Auditors working on an oil and gas audit will find the information they need in the [Auditing Revenues from Oil and Gas Extraction](#) and [Auditing Financial Assurances for Site Remediation](#) sections.

Finally, a short section on [The Reporting Phase](#) concludes this part of the Practice Guide.

[Back to Table of Contents](#)

Determining the Audit Focus

Once auditors have a good understanding of the oil and gas sector in their jurisdiction and have identified all important [government responsibilities](#) in this sector, they have to determine where the key risks are and narrow down options to eventually arrive at a manageable audit focus.

Depending on the results of the risk analysis conducted and on the general preferences of audit offices about the breadth of audits, audits of oil and gas extraction will cover several areas of responsibility in a single report or will focus exclusively on one area of responsibility. For example:

- Quebec's [2011 audit](#) of the management of exploration and production activities in the shale gas sector is an example of an audit with a broad audit focus because it examined elements from all five responsibility areas presented in [Figure 5](#).
- In contrast, Newfoundland and Labrador's [2008](#) and [2013](#) audits of royalties from offshore oil extraction activities are examples of audits with a narrow audit focus because they were entirely focused on a single area of responsibility (revenue collection).

Both of these approaches (broad or narrow focus) are equally valid and the choice of approach is up to each audit office.

To determine the audit focus, auditors have to conduct further research in the areas that they have identified as relevant and important. While these areas may include environmental management, enforcement activities, or other aspects of oil and gas extraction activities, this part of the Practice Guide is strictly concerned with revenues and with financial assurances for site remediation. (Auditors can find information on other topics on the [WGEI website](#)). **Table 3** presents a non-exhaustive list of high-level questions that auditors can research as part of their efforts to determine whether and to what extent their audit should focus on revenues from oil and gas extraction. **Table 4** presents a similar list of questions about financial assurances.

Table 3 – High-Level Questions About Revenues from Oil and Gas Extraction

Questions
<ul style="list-style-type: none"> ▪ Are the revenues from oil and gas extraction material? (Each source of revenue should be assessed individually and materiality should also be assessed in the aggregate. While large revenues can be significant on their own, some less material sources of revenues may also be significant because of their function. For example, leases, licences, and permits may be important because they enable departments to know who should be paying royalties and fees.) ▪ Is there a significant difference between predicted and actual revenues? If so, what is the explanation for this difference? ▪ Are there any new revenue sources (for example, a new resource with its own royalty system, such as shale gas extracted through fracking)? ▪ Has new relevant legislation or regulation been introduced or have significant changes been made to existing legislation and regulation recently? ▪ When was the last review of the revenue framework conducted? When is the next one planned? ▪ Where significant changes in revenues are observed, are they in line with current market conditions and production levels? ▪ Has the revenue framework (and supporting regulations) been criticized for being overly complex or unclear? Is there significant public interest in the topic? ▪ Have there been any public complaints or reporting of any inappropriate practices in the sector (transfer mispricing, for example)? ▪ Have annual financial audits identified significant or chronic issues with regard to the collection of revenues from oil and gas extraction? ▪ Is there a regulated royalty audit regime in place? If so, is there 100 percent audit coverage or risk-based coverage? Are audits completed on a timely basis? ▪ Is there significant reliance on self-reporting of production levels? ▪ Does the government have sufficient expertise to verify information reported by the private sector? ▪ Have previous audits of oil and gas revenues been conducted by the audit office? Has progress been made by the government to address prior recommendations? ▪ Is there segregation of duties between the collection of revenues and the assessment of the completeness of revenues received? ▪ Has the government clearly established the objective it is pursuing through its revenue framework for the oil and gas sector? ▪ Is there legislation or regulation in place to ensure the public has access to reliable information on the payments the government receives from oil and gas companies?

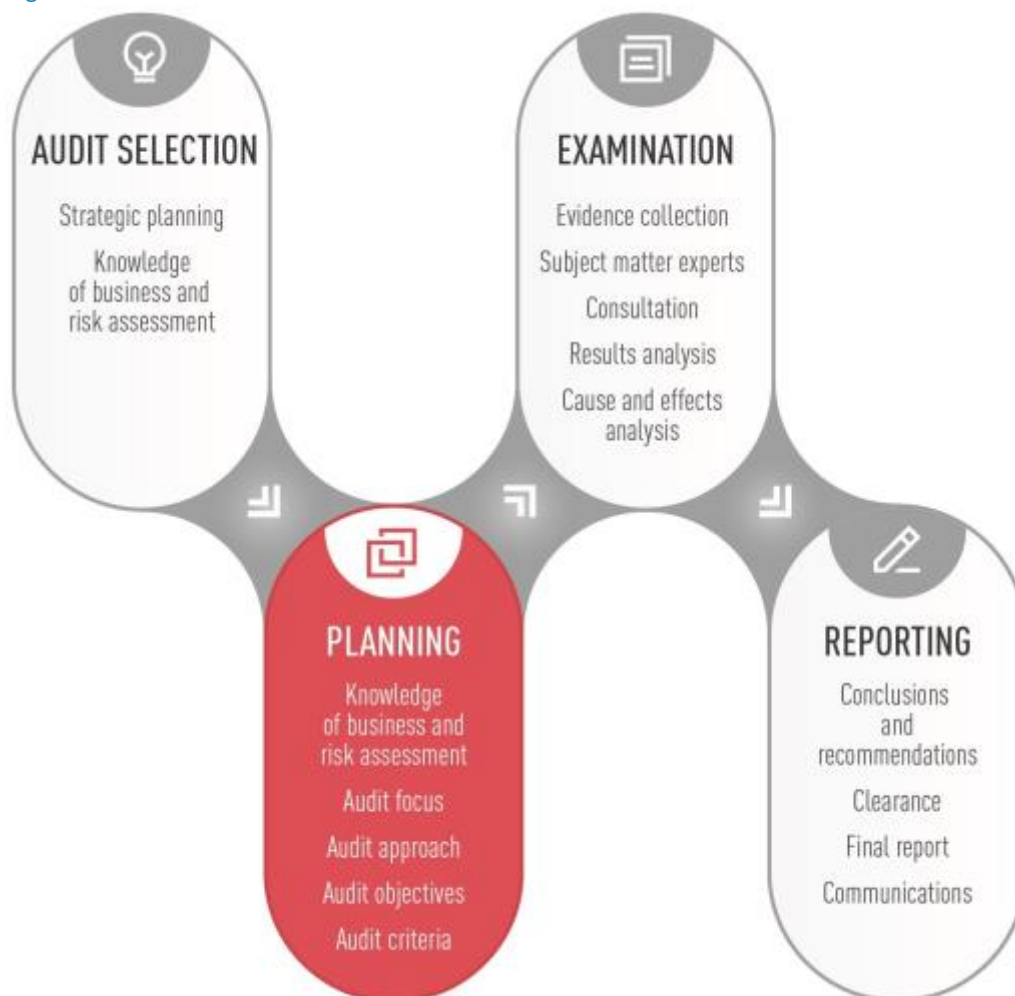
Table 4 – High-Level Questions About Financial Assurances for Site Remediation

Questions
<ul style="list-style-type: none"> ▪ Is there a regulated system of financial assurances for site remediation in place? Is the system recent or well-established? Has a remediation fund been established? ▪ What is the current cost estimate (potential liability) for rehabilitating all oil and gas wells and facilities in the jurisdiction? ▪ What is the state/risk of unfunded liability in the jurisdiction? Is the risk increasing over time? ▪ If there is a remediation fund, what is the current balance of this fund? ▪ Have there been any recent or looming changes in environment standards or legislation that are expected to impact required securities? ▪ Does the duration of the securities match the expected duration of the expected liability? ▪ Is there documented guidance on how to estimate remediation costs? ▪ Are remediation cost estimates periodically reviewed by the government or an independent expert? ▪ If regulations allow for self-insurance, what is the relative frequency of self-insurance by oil and gas companies in the jurisdiction? ▪ Are there mechanisms for regular monitoring of sites and monitoring of associated securities? Are these mechanisms implemented? What is the frequency of site visits? ▪ Are the licensing and inspection functions segregated? ▪ Is there a process to ensure that financial assurances are released only when compliance with site remediation requirements is achieved and documented? ▪ Are site inspections providing sufficiently complete assessments? (for example, can inspections identify underground contamination?) ▪ Are there sufficient penalties in place to encourage compliance with financial assurance requirements?

[Back to Table of Contents](#)

Auditing Revenues from Oil and Gas Extraction

The Planning Phase



At this stage of the audit process, it is assumed that auditors have decided to include revenues from oil and gas extraction in their audit. However, they may not yet know exactly which revenues and which controls to audit, nor which audit objectives and criteria to use in their detailed audit plan.

This section of the Practice Guide is intended to help auditors answer these questions. It is organized according to the key actions and decisions that need to be made when conducting detailed planning for the audit:

- [Acquiring knowledge of business and assessing risk](#)
- [Drafting audit objectives](#)
- [Selecting audit criteria](#)

Acquiring knowledge of business and assessing risk

Audit procedures typically require auditors to acquire knowledge of the organization and subject matter being audited and to prepare a risk-based audit plan.

In practice, this means that, once the decision to audit the completeness of revenues from oil and gas extraction (and related questions) has been made, the audit team needs to start conducting research and interviewing officials in order to acquire (or further develop) a sound knowledge of business and an understanding of the risks facing the organizations being audited. The information collected will be used to determine what the main risk areas are and where audit efforts should be directed.

In order to develop their plan for auditing the completeness of oil and gas revenues, auditors will need to answer three main questions:

- What are the sources of revenues?
- Which revenues to audit?
- Which controls to examine?

Revenues from oil and gas come from the exploration and production phases of extraction projects. Revenues from the exploration phase come from the fees charged for leases and licences, plus any penalties that can be applied when leaseholders do not meet their lease obligations. (Leaseholders may be required to conduct a minimum of work each year on each of their parcels; failure to meet these requirements may result in fines or in leases being cancelled). Lease revenues can come from fixed rates for every unit of land (or sea floor) or are determined by the results of lease auctions. Auditors need to determine which option is used in their jurisdiction and obtain information on the annual revenues generated by lease payments. Once they have this information, auditors can determine whether the materiality of lease payments is sufficient to justify including this subject in the audit.

Exploration phase revenues can also come from the auction of exploration rights. Such auctions can generate very large revenues in certain jurisdictions when economic conditions are favourable. Given their importance and competitive nature, there is a risk of fraud and corruption in auctions of exploration rights. However, because rules of auctions vary from one jurisdiction to another, and because there is a lack of information on best practices in this area, this Practice Guide does not provide specific guidance on how to audit auctions for exploration rights.

Revenues from the production phase of oil and gas projects come from royalties. As discussed previously, the [revenues from royalties](#) can be very substantial in many jurisdictions. As such, materiality will often be enough to justify inclusion of royalty payments in the audit.

Finally, some revenues may also come in the form of fines paid by private sector companies due to non-compliance with a federal or provincial regulation on oil and gas extraction. This source of revenue will often be small compared with lease payments and royalties and may not be material enough to include in the audit (unless there are indications that a government is losing significant revenues due to ineffective enforcement).

For each source of revenues selected for audit, a number of areas can be examined, including:

- the design of the revenue framework,
- the processing of payments,

- the internal review and auditing of payments, and
- the measures adopted to increase the transparency of payments and to prevent and detect fraud.

Each of these areas is described in more detail below and some of the controls that could be audited under each area are highlighted.

Readers should note that while these categories are useful for understanding the subject matter, the areas may not be so easily distinguished in real life and administrative structures may vary by jurisdiction.

The design of the revenue framework: As explained in the [Concepts and Context](#) part of this Practice Guide, governments can collect various revenues, including royalties, to ensure they are compensated for the extraction of natural resources on Crown lands or on the seabed.

While the decision to use one revenue framework over another is a political decision that auditors are not mandated to challenge, auditors can look at some elements of the decision-making processes. For example, were decisions based on sufficient information and analysis? They can also examine whether the revenue framework is periodically reviewed and improved. For example, is the framework too complicated, subject to interpretation, or not reaching its objectives? Auditors can also look at the processes in place to establish, communicate, and regularly update royalty rates for each extracted resource. The Practice Guide provides some guidance on auditing these areas.

Table 5 includes examples of knowledge of business questions that auditors can ask about the design of the revenue framework during the planning phase (the list is not exhaustive). Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Auditors can also look at wider strategic planning questions, such as whether a government has taken appropriate measures to manage the impacts of resource revenues on the national economy in order to avoid what is often called the Dutch disease (a general decline of exports that results from an increase in value of the national currency caused by a sharp influx of foreign currency following the discovery of large oil reserves). However, the Practice Guide does not include specific guidance on how to audit such wide-ranging strategic planning questions.

Table 5 – Design of the Revenue Framework: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
Establishing the revenue framework and setting rates	<ul style="list-style-type: none"> ▪ Which laws, regulations, and policies provide the framework for collecting revenues from oil and gas extraction? When were these documents last updated? ▪ Have royalty rates and other fees been regulated for oil and gas extraction? When were the rates last updated? ▪ Are there clear objectives for the revenue framework? Do they align with current government priorities and policy objectives?

Sub-topic	Knowledge of Business Questions
	<ul style="list-style-type: none"> ▪ If recent changes were made to supporting legislation, have all changes been implemented? ▪ Where relevant, does the framework include consideration of relevant Aboriginal land rights issues? Are there recent court decisions on Aboriginal land use and revenue sharing that should be reflected in the framework? ▪ If the revenue framework includes exemptions, special deductions, or royalty credits, is there a clear, documented objective or rationale for these measures? ▪ Does the revenue framework’s design facilitate the audit of leaseholders’ self-declared royalties by providing government auditors with clear access to information rights? ▪ Has independent assessment or verification of production levels and reported volumes been built into the framework? ▪ Were stakeholder consultations held during the development of the revenue framework? What was their scope? ▪ Were the fiscal impacts of the revenue framework fully assessed and documented? ▪ Are there unique deductions provided to the private sector in calculating the amount of royalties owed to the government? ▪ Was consideration given to implementation questions during the design of the revenue framework? (would the proposed framework be easy to apply in practice? were challenges expected?) ▪ Was a dispute resolution mechanism established?
<p>Clear rules and guidance</p>	<ul style="list-style-type: none"> ▪ Are the rules established to calculate the revenues due to the government written clearly, without using ambiguous terms? ▪ Is clear guidance provided to leaseholders on how to calculate the royalties they owe? ▪ Is the guidance updated as necessary to reflect changes in applicable regulations and lessons learned from experience and audits? ▪ Are changes communicated to leaseholders in a timely manner? When was the guidance last updated? ▪ Is there up-to-date regulation on oil and gas production measurement (reflecting industry best practices)?

Sub-topic	Knowledge of Business Questions
Framework reviews and rate updates	<ul style="list-style-type: none"> ▪ Is the revenue framework periodically reviewed? ▪ Are royalty rates regularly reviewed, benchmarked, and updated? ▪ Do royalty increases take into account multiple factors, including the competitiveness of the resource markets, the demand for specific resources, or the government’s social and economic goals?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the design of the revenue framework.

Auditors should consider including the design of the revenue framework in their audit plan if their preliminary audit work indicates the following:

- The legal framework that supports the revenue framework, or the revenue framework itself, has not been updated in a very long time and this has drawn criticism from the industry or other stakeholders.
- The revenue framework has not been updated to take into account new types of extracted resources in a jurisdiction (natural gas from fracking, for example) or significant changes in market resource prices.
- The revenue framework had been updated, but the guidance provided to the industry to calculate royalties or other payments does not reflect these changes.
- The decisions leading to the revenue framework were poorly documented or there are indications that the decisions were not based on evidence and a sound analysis of available options.
- The revenue framework is unnecessarily complex, or includes vague terms that are open to interpretation, which results in many implementation problems.
- The revenue framework relies heavily on reporting by oil and gas producers with limited or no provisions for independent review and audits.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include the design of the revenue framework in their audit plan.

The processing of payments: This area includes the routine systems and processes to identify all leaseholders, process their royalty returns, and collect their payments, including arrears and any penalties applicable for late payments. However, this area does not include additional internal controls over payments, like audits and inspections, which are covered in the next section.

The audit focus for the collection and processing of payments could also include questions related to internal capacity (skilled personnel and IT systems) and coordination between responsible organizations. **Table 6** includes examples of knowledge of business questions about the processing of payments that auditors can ask during the planning phase. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 6 – Processing of Payments: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
Controls over receipt of payments	<ul style="list-style-type: none"> ▪ Is there a database of leaseholders that are expected to pay royalties? If so, is this database regularly reviewed for completeness and updated? (For example, is it reconciled with other government information about resource extraction activities.) ▪ Is there an electronic system that oil and gas companies can use to produce and submit their royalty returns? ▪ Are there systems and procedures to determine what is owed, to identify late returns or payments, and to ensure amounts owed are paid? ▪ Is there an “audit trail” in the royalty system to track entries and revisions to entries posted to the system? ▪ Is the government maintaining a payment schedule and ensuring that oil and gas companies comply with this schedule? ▪ Is there guidance for staff on how to collect royalty payments and manage payments in arrears? ▪ Is follow-up action promptly taken in cases of late payment or underpayment (above a certain percentage of the amount due)? Are penalties applied? Are there increased penalties for persistently late payers? Are penalties sufficiently high to deter non-compliance? ▪ Is interest collected on underpayments and late payments? ▪ Are actual revenues compared with projected revenues and significant variations explained? ▪ Is there a performance measurement framework to assess the department’s performance in assessing and collecting royalties (complete with annual targets)? ▪ Are surveys of oil and gas companies used to supplement the assessments of performance? ▪ Have internal audits identified persistent issues with the collection of payments?
Staffing and training	<ul style="list-style-type: none"> ▪ Are there staff dedicated to administering royalty returns and staff dedicated to auditing returns? (In other words, are they separate jobs, therefore giving auditors more time for actual audits?) ▪ Are there challenges related to ensuring there is always sufficient qualified staff to handle royalty returns and payments? ▪ Is relevant training provided to staff? ▪ Are there policies on conflicts of interest, ethics, and independence?
Coordination	<ul style="list-style-type: none"> ▪ Where there is more than one responsible organization, is there a formal coordination agreement in place (memorandum of understanding or other)?

Sub-topic	Knowledge of Business Questions
	<ul style="list-style-type: none"> ▪ Are the roles and responsibilities of all parties clearly documented? ▪ Are the information needs of each responsible organization defined?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the processing of payments made by oil and gas companies for the extraction of Crown-owned natural resources.

Auditors should consider including the processing of payments for oil and gas extraction in their audit plan if their preliminary audit work indicates the following:

- There is a lack of internal guidance on how to collect royalty payments (and other fees) and manage payments in arrears.
- There is evidence that internal rules are not applied properly and consistently.
- Penalties for late payments are not applied and interest is not being collected.
- Internal audits have identified persistent issues with the collection of payments.
- In cases where responsibilities for collecting payments are shared between two or more organizations, there is no formal agreement that defines the respective roles and responsibilities of each organization and the information they need to share with each other.
- The collection and processing of royalty payments or other fees is performed by a service provider on behalf of the government.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include the processing of payments for oil and gas extraction in their audit plan.

Internal review and auditing of payments: This area includes all the systems and processes to ensure the accuracy and completeness of all royalty payments made by leaseholders. This can include inspections, data validation, recalculations, and audits of payments. While these controls are not necessarily applied to all payments and usually require specialized expertise for their execution, they complement the routine controls over the processing of payments and together they form an integrated system.

Royalty payments are usually based on production and/or profit data provided by leaseholders. Many factors can enter into the calculations of royalties payable, such as production volumes, market prices, exchange rates, and various deductions. Governments have an incentive to ensure that this data is complete and accurate in order to receive the full amounts they are entitled to. For this purpose, governments may regulate measurement equipment and practices to ensure accuracy and consistency in production measurement. They may also conduct regular inspections to ensure requirements are met and reduce the risk of fraud (for example, diversion of oil or gas before measurement points or false declaration of production numbers).

The assessment of royalties can therefore be complex. In the absence of robust internal controls, there is a risk that governments will not receive all the amounts they are entitled to for the extraction of oil and gas resources in their jurisdiction.

Table 7 includes examples of knowledge of business questions about the review and internal audit of payments that performance auditors can ask during the planning phase. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 7 – Review and Auditing of Payments: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
Data validation	<ul style="list-style-type: none"> ▪ Are oil and gas companies required to provide supporting evidence or independent verification of their royalty returns? ▪ Is volume data collected from pipeline operators and processing facilities compared with volumes reported at the well by oil and gas producers? ▪ Is there guidance for staff on how to validate data provided by companies? ▪ Is there a list of indicators staff can use to assess the accuracy and completeness of information provided in received returns? Is this list used to identify cases that warrant further verification? ▪ Is the responsible organization making use of revenue streams models to forecast revenues and analyse declared revenues against predictions? ▪ Is the data provided by oil and gas companies reviewed and validated (for example, exchange rate, oil prices, royalty rate, production data and exports)? Are royalties recalculated based on data provided? Are those reviews documented? ▪ Are there electronic systems to facilitate the review, recalculations, and analysis of production data and royalties provided by resource extraction companies? ▪ Are there timeliness standards for completing reviews and data validation? ▪ Is there a backlog of reviews and reconciliations to complete?
Audits of payments	<ul style="list-style-type: none"> ▪ Are audits conducted to validate that payments made by companies are accurate? If so, are returns audited every year or only in some years? ▪ Is there a risk-based audit strategy? ▪ Are audits conducted to assess whether transfer mispricing is practiced to reduce declared profits? ▪ Are planned audits conducted? Are audits completed in a timely manner? ▪ Is there up-to-date audit guidance and documented audit procedures (including on how to audit transfer pricing)? ▪ Have recent audits indicated the existence of systemic risks affecting the

Sub-topic	Knowledge of Business Questions
	<p>completeness of revenues?</p> <ul style="list-style-type: none"> ▪ Is the entity obtaining all the evidence it is entitled to from the audited companies? ▪ Is the information requested by auditors provided in a timely manner? ▪ Are the access rights of public sector entities to private sector financial information for royalty audit purposes clearly set out in laws, regulations, or special agreements?
Inspections of production measurement equipment	<ul style="list-style-type: none"> ▪ Are inspections required by regulation to provide assurance on production data provided by resource extraction companies? ▪ Are there controls to ensure that: <ul style="list-style-type: none"> ○ All oil and gas passes through designated meters (no by-pass)? ○ Meters are properly calibrated to ensure accurate production data is collected? ○ No tempering with calibrated meters takes place? ▪ Is the frequency and coverage of inspections fixed by regulation? ▪ Is there a risk-based inspection strategy? ▪ Are all planned inspections conducted? Is there an inspection backlog? ▪ Are the results of inspections documented?
Quality management system	<ul style="list-style-type: none"> ▪ Is the data validation/audit/inspection process subject to a periodic performance assessment? ▪ Are adjustments made based on findings?
Staffing and training	<ul style="list-style-type: none"> ▪ Are all auditor/inspector positions staffed? ▪ Are there sufficient qualified auditors/inspectors to conduct all planned audits/inspections? ▪ Is specialized training provided to auditors and inspectors? Is there a record of training provided? ▪ Is there a hiring and retention strategy for auditors and inspectors? ▪ Are there clear independence requirements for auditors and inspectors? Have these requirements been communicated to staff? ▪ Are annual independence declarations required from auditors and inspectors? Are all required declarations on file?
Coordination	<ul style="list-style-type: none"> ▪ Where more than one organization is auditing a private sector company, are there coordination arrangements in place to share information and reduce

Sub-topic	Knowledge of Business Questions
	duplication of efforts?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the completeness and accuracy of payments made by oil and gas companies for the extraction of Crown-owned natural resources.

Auditors should consider including the completeness of revenues from oil and gas extraction in their audit plan if their preliminary audit work indicates the following:

- The data provided by oil and gas companies is not validated by the responsible organization or by an independent third party (there is significant reliance on self-reported data from the private sector).
- There are significant data validation, audit, or inspection backlogs.
- Audits and inspections are not conducted on a timely basis because of staffing issues (for example, high turnover, long recruitment processes).
- Auditors in responsible organizations are not receiving all the information from oil and gas companies they are entitled to.
- The site inspection strategy is not risk-based.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include the completeness of oil and gas revenues in their audit plan.

Fraud prevention and transparency: Because the revenues that can be generated from oil and gas extraction are very significant, this sector has been a frequent target of fraud and corruption in many jurisdictions, especially in developing countries. Rigged lease auctions, diversion of the resource before production measurement points, false production declaration, and misappropriation of revenues are some of the most common frauds observed in the sector.

It has been shown that transparency is the primary means of reducing fraud and corruption in the resource sector. For this reason, international initiatives have been undertaken to increase transparency (for example, the [Extractive Industries Transparency Initiative](#)). In many countries, new laws and regulations require leaseholders to disclose all their payments (above a defined threshold) to government. Where such provisions exist, auditors can look at compliance with the applicable requirements and assess whether transparency is sufficient. Auditors can also look at other systems and practices intended to reduce the incidence of fraud and corruption, including codes of ethics and policies on conflicts of interest.

Table 8 includes examples of knowledge of business questions about fraud prevention and transparency that auditors can ask during the planning phase. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 8 – Fraud Prevention and Transparency: Examples of Knowledge Business Questions

Sub-topic	Knowledge of Business Questions
Policies and controls	<ul style="list-style-type: none"> ▪ Has the responsible organization assessed the risk of fraud in the collection of revenues from oil and gas extraction? ▪ Is there a code of values and ethics? ▪ Is there a policy on conflicts of interest and a requirement for staff to provide an annual independence declaration? ▪ Are there controls in place to manage the risk of fraud and corruption in relation to the collection of revenues from natural resource extraction? ▪ Is there a mechanism in place for personnel to report suspected instances of wrongdoing without fear of reprisal? ▪ Are the responsibilities for facilitating investments in natural resources extraction industries segregated from responsibilities for regulating these industries and collecting royalties? ▪ Are the responsibilities for assessing royalties due segregated from responsibilities for collecting payments? ▪ Are there unexplained or unclear differences between the information reported for royalty calculation and information reported elsewhere by oil and gas companies?
Transparency and reporting	<ul style="list-style-type: none"> ▪ Is there a legal requirement for governments to report all the payments they receive from oil and gas companies? If so, what is the source of this requirement and what form does the reporting take? ▪ Is information on the process used for auctioning oil and gas exploration rights, and the results of auctions (number of bids received, winning bid), disclosed to the public?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to fraud and transparency.

Auditors should consider including fraud prevention and/or transparency in their audit plan if their preliminary audit work indicates the following:

- Responsible organizations have not assessed the risk of fraud in relation to the collection of oil and gas revenues.
- Responsible organizations have failed to adopt basic policies on ethics and independence.
- Responsibilities for assessing royalties and collecting payments have not been segregated, creating a risk of fraud with regard to the collection of royalties.

- A government has committed to publish the payments it receives from oil and gas companies but has taken no concrete steps to make this happen.
- Legislation requiring a government to publish the payments it receives from oil and gas companies is not being complied with.
- Potential conflicts of interest or inappropriate relationships amongst key decision makers.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include fraud prevention and transparency in their audit plan.

Drafting audit objectives

All performance audits need clearly stated objectives that are worded in a manner that allows auditors to conclude against them. Audit objectives should be realistic and achievable and give sufficient information to audited organizations about the focus of the audit.

An audit can have one or several objectives depending on its breadth. Office practice will also influence the number of objectives and whether or not sub-objectives are used. (Some audit offices never use sub-objectives). Sub-objectives can be included in audit plans (for example, one for each line of enquiry), but auditors who decide to do so will still be expected to conclude on their main audit objective(s).

The objective of an audit that will look at the completeness of revenues from oil and gas extraction (and related questions) will depend on whether that is the sole focus of the audit. If the audit will broadly examine the development of the oil and gas sector, including the collection of royalties or other fees, then a general objective will be appropriate. For example:

- *To determine whether the responsible organizations have taken steps to ensure that shale gas extraction activities are developed in accordance with government's policy and objectives.*

This objective could be supported by sub-objectives related to the main areas included in the audit. One of these sub-objectives could be about the collection of royalties:

- *To determine whether the department has effective controls in place to ensure the completeness of royalties payable.*

If an audit has a compliance focus, the same principles will apply. In this case, the broad objective could be:

- *To determine whether the department has managed oil and gas resources in compliance with The Oil and Gas Act and regulations.*

A sub-objective on revenues could be added to support the main objective:

- *To determine whether the control of oil and gas production measurement performed by the responsible*

organization ensures the reliability and integrity of oil and gas production data used to assess royalty payments.

If the audit is strictly about the collection of revenues from oil and gas extraction, then the audit objective can be narrower. For example:

- *To determine whether the government has designed and implemented control systems that provide assurance that it is collecting all oil and gas royalties payable from leaseholders.*

Auditors could also decide that the four areas detailed in the previous section are adequate in their context and adopt an overall audit objective about the collection of revenues supported by a sub-objective for each of the areas:

- the design of the revenue framework,
- the processing of payments,
- the internal review and auditing of payments, and
- the fraud prevention and transparency measures adopted to increase the transparency of payments and reduce the incidence of fraud and corruption.

Selecting audit criteria

Audit criteria represent the standards that audited organizations are expected to meet. Audit criteria are a key contributor to an audit's strength and potential impact. Audit procedures focus on determining whether criteria are met or not met. Suitable criteria are relevant, complete, reliable, neutral, and understandable.

Finding suitable criteria is a challenge for any performance audit, especially where there is no recognized source of accepted criteria. There is no such recognized source of criteria for auditing the completeness of revenues from oil and gas extraction (and related questions).

The examples of criteria presented in **Tables 9, 10, 11, and 12** have been compiled from published audits and modified to be uniform in style. Where there were gaps, criteria were added. The list of criteria was then discussed by members of the Advisory Group that supported the development of this Practice Guide. The criteria were improved based on their comments. Finally, all the audit offices represented by the Canadian Council of Legislative Auditors, had an opportunity to comment on the proposed criteria before the Practice Guide's publication (comments were also received from some members of the INTOSAI Working Group on the Audit of Extractive Industries).

The criteria in **Tables 9, 10, 11, and 12** are not exhaustive and can be modified according to the specific needs of auditors. They can also be used as sub-criteria in cases where it is possible to draft a criterion with a broader coverage. The tables provide sample audit criteria in the following areas:

- [Design of the revenue framework](#)
- [Processing of payments](#)

- [Internal review and auditing of payments](#)
- [Fraud prevention and transparency](#)

Table 9 – Examples of Audit Criteria for Auditing Oil and Gas Revenues: Design of the Revenue Framework

Sub-topic	Audit Criteria
Establishing the revenue framework and setting rates	<ul style="list-style-type: none"> ▪ The royalty regime or revenue framework was established after potential options were evaluated using evidence-based methods. ▪ The government has established clear, documented objectives for the oil and gas revenue framework. ▪ The revenue framework reflects current legislative, regulatory, and policy requirements. ▪ Industry and other stakeholders were consulted as part of the policy-making process. ▪ The rationale for final decisions has been documented. ▪ The revenue framework and applicable rates guarantee that the government receives revenue from oil and gas extraction that is consistent with its objectives, while maintaining the industry’s competitiveness in the jurisdiction. ▪ Roles and responsibilities for setting rates and collecting royalties and other resource revenues are clearly defined and documented.
Clear rules and guidance	<ul style="list-style-type: none"> ▪ Regulations, policies, and directives clearly set out requirements on how companies should measure and report their oil and gas production, and pay the associated royalties. ▪ The organization has provided guidance, including clear definitions and standard forms, to the industry on how companies should calculate and transmit their royalty payments. ▪ The organization regularly keeps companies informed of changes to the revenue framework and related processes. ▪ The revenue framework’s design includes a provision describing the access right to the records of private companies that the government requires for audit purposes. ▪ The organization has systems and processes for promoting the consistent application of the resource revenue framework, including providing information to oil and gas companies on the interpretation of legislation and regulation, and the results of recent judgments.
Framework reviews and rate updates	<ul style="list-style-type: none"> ▪ Royalty rates and other fees are reviewed regularly to ensure they still reflect fair market value, policy, or other factors.

Sub-topic	Audit Criteria
	<ul style="list-style-type: none"> ▪ The resource revenue framework, including relevant regulations, is reviewed periodically and modified as needed to take into account the result of performance assessments and other relevant factors (for example, evolution of resource markets, legislative or policy changes, economic circumstances, industry development, relevant court decisions). ▪ The results of periodic reviews and the rationale for significant changes are documented. ▪ Controls are regularly tested to assess their effectiveness and corrective actions are taken where needed.

Table 10 – Examples of Audit Criteria for Auditing Oil and Gas Revenues: Processing of Payments

Sub-topic	Audit Criteria
Controls over receipt of payments	<ul style="list-style-type: none"> ▪ The organization ensures that all companies comply with reporting requirements and follows up on outstanding items in a timely manner. ▪ The organization has a complete database of all oil and gas wells in its jurisdiction and keeps this database up to date. ▪ The organization knows which companies should be paying royalties for oil and gas extraction. ▪ The entity uses predictive analytics to estimate expected revenues and follows up on deviations from expected results in a timely manner. ▪ Automated systems are in place to: <ul style="list-style-type: none"> ○ enable the transmission and filing of royalty returns by oil and gas companies and ○ track expected and received royalty returns. ▪ The organization ensures that companies submit their royalty returns and related data in a timely manner and follows up on late submissions. ▪ To encourage compliance, the organization penalizes leaseholders that continually make late or inaccurate returns. ▪ Penalties for late payments or inaccurate payments are sufficiently high to promote behaviour change. ▪ The organization has a process in place to communicate deficiencies found in royalty returns or related data, corrective action to be taken, and the expected timelines for completing corrective action.
Staffing and training	<ul style="list-style-type: none"> ▪ The organization has determined the skills it needs its personnel to have in order to effectively process royalty returns and has ensured that it has sufficient qualified personnel to do so.

Sub-topic	Audit Criteria
	<ul style="list-style-type: none"> ▪ Staff receive adequate training in a timely manner to ensure they can perform their duties effectively. ▪ Strategies are in place to reduce staff turnover and retain skilled staff in order to ensure that there is always sufficient staff to process royalty returns.
Coordination	<ul style="list-style-type: none"> ▪ Responsible organizations have clearly defined and communicated their respective roles and responsibilities. ▪ Responsible organizations have clearly identified what information they need to share with each other.

Table 11 – Examples of Audit Criteria for Auditing Oil and Gas Revenues: Internal Review and Auditing of Payments

Sub-topic	Audit Criteria
Completeness of revenues	<ul style="list-style-type: none"> ▪ The organization has designed and implemented controls to identify potential errors in submitted royalty or production tax returns. ▪ Automated systems are in place to help staff recalculate royalties payable. ▪ The organization verifies data submitted by oil and gas companies and ensures that it is reliable. ▪ The organization conducts inspections and does in-depth, risk-based audits in a timely manner to ensure it collects all royalties payable. ▪ The organization has a process in place to communicate deficiencies found, corrective actions to be taken, and the expected timelines for corrective actions. ▪ The organization ensures that follow-up on recommended corrective actions is done in a timely manner. ▪ The organization receives requested information in a timely manner and uses all the legal and administrative means at its disposal to obtain requested information when required. ▪ IT systems are kept up to date and reflect changes to the revenue framework.

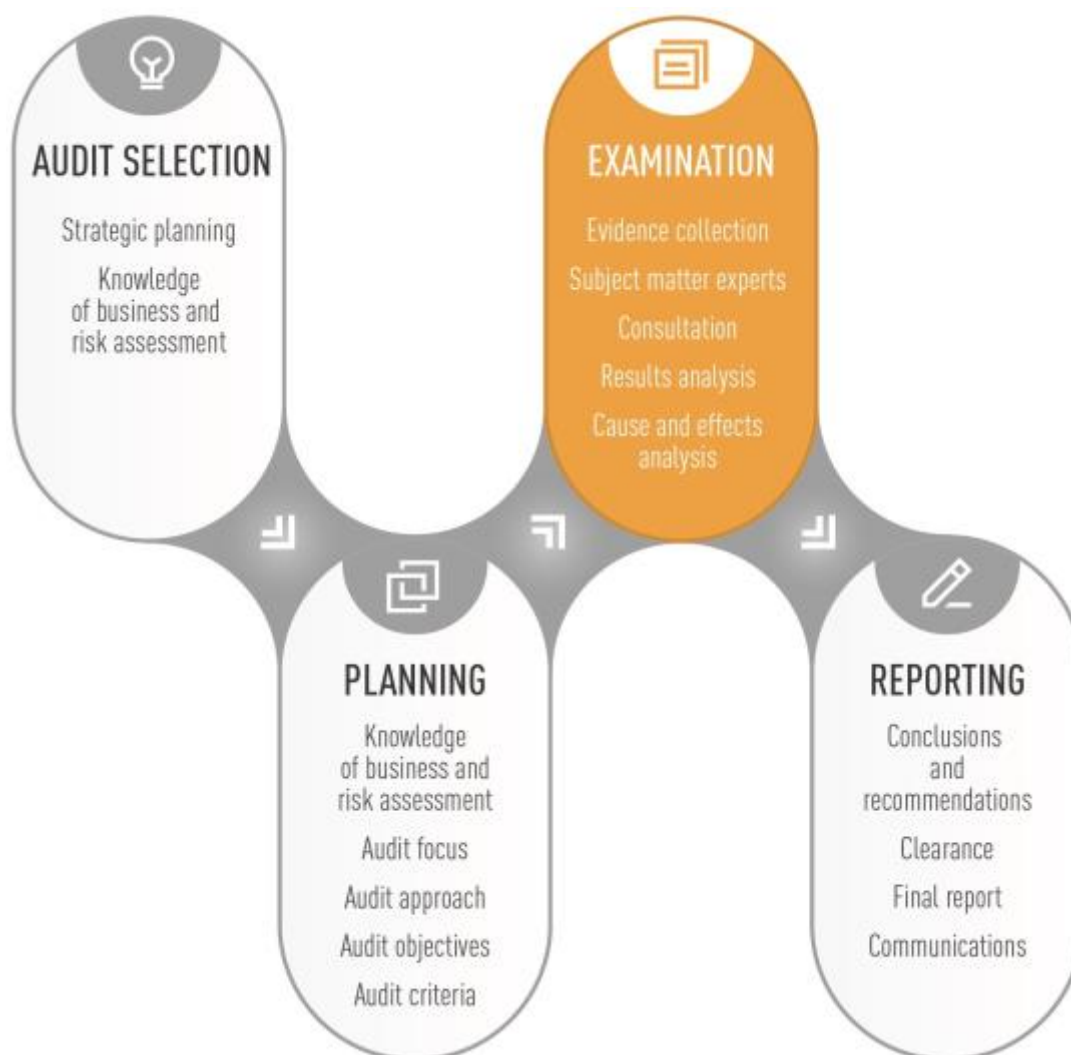
Sub-topic	Audit Criteria
Staffing and training	<ul style="list-style-type: none"> ▪ The organization has identified its staffing requirements and ensured that it has sufficient qualified personnel to conduct all reviews, audits, and inspections in a timely manner. ▪ Staff receive adequate training in a timely manner to ensure they can perform their duties effectively. ▪ Strategies are in place to reduce staff turnover and retain skilled staff in order to ensure that there is always sufficient staff to conduct required inspections and audits.
Coordination	<ul style="list-style-type: none"> ▪ The responsible organizations coordinate their activities to ensure an effective and efficient oversight. ▪ The responsible organizations ensure that follow-up on recommended corrective actions is done in a timely manner.

Table 12 – Examples of Audit Criteria for Auditing Oil and Gas Revenues: Fraud Prevention and Transparency

Sub-topic	Audit Criteria
Policies and controls	<ul style="list-style-type: none"> ▪ The organization has assessed the risks of fraud and corruption in its operating environment. ▪ The organization has policies and controls in place to manage the fraud and corruption risks. ▪ Responsibilities for assessing amounts due and for collecting payments are segregated. ▪ Policies and controls are in place to ensure that auditors, inspectors, compliance enforcement staff, and consultants are independent from oil and gas companies.
Transparency and reporting	<ul style="list-style-type: none"> ▪ Information on the revenue framework and current rates, fees, and formulas is readily available to the public. ▪ The government complies with legislative or policy requirements related to the publication of all the payments it receives from oil and gas companies.

[Back to Table of Contents](#)

The Examination Phase



During the examination phase of a performance audit, audit teams must conduct procedures that will yield sufficient appropriate evidence to:

- determine whether audit criteria are met,
- conclude on audit objectives, and
- document and support these conclusions.

During the planning phase, auditors carefully consider which audit tests and procedures to include in their detailed **audit program** and make decisions based on (1) the type of evidence they will require to reach **audit conclusions** against their audit criteria and (2) an assessment of the time, expertise, and resources they would require to conduct each test or procedure. Ultimately, the audit team has to plan audit procedures that will provide sufficient and appropriate evidence while respecting the audit's budget.

However, planning and conducting audit procedures may not always be easy and straightforward in an audit of oil and gas revenues. From mandate limitations to finding the necessary expertise, performance auditors may have to

deal with a number of challenges before they can obtain all the information they seek and conclude on their audit objective(s).

This section of the Practice Guide covers:

- [Evidence sources and audit tests](#) for audits of oil and gas revenues
- [Challenges](#) involved in auditing oil and gas revenues

Evidence sources and audit tests

Documentary, testimonial, physical, and analytical evidence can all play a role in audits of oil and gas revenues. The main sources of evidence that will be useful in this context are:

- a review of relevant documents,
- interviews,
- testing of controls and IT systems, and
- site visits.

Review of relevant documents: By their nature, performance audits rely heavily on documentary evidence, and audits of oil and gas revenues are no exception. Auditors need to consider everything from evidence of the rules that government organizations and oil and gas companies have to meet to evidence that controls have been put in place and are functioning as intended. Documentation needs to be gathered, reviewed, and analyzed by auditors, then added to the audit file if it is deemed relevant to support **audit observations** and conclusions.

Table 13 provides many examples of documents that may prove useful as audit evidence in an audit of oil and gas revenues.

Table 13 – Example of Documentary Evidence that May Be Useful in an Audit of Oil and Gas Revenues

Documents
<ul style="list-style-type: none"> ▪ Laws, regulations, and policies that govern the oil and gas sector, including the revenue framework ▪ Descriptions of the revenue framework, royalty regimes, exploration rights application process, auction processes, and so on ▪ Evidence of public consultations about the revenue framework ▪ Analysis supporting the development of the revenue framework ▪ Reports of revenue framework reviews ▪ Process maps and narratives ▪ Risk analysis of where there may be uncollected revenues or fraud ▪ List of oil and gas wells in the jurisdiction, list of leaseholders ▪ Guidance to the industry on how to calculate royalties and other relevant payments ▪ Communications to the industry about changes in laws, regulations, or processes ▪ Training material and guidance to staff on how to process and review payments from oil and gas companies

Documents

- Royalty returns from oil and gas companies and evidence of their review by the responsible organization
- Description of the site inspection process, inspection strategy, record of inspections conducted (and backlog, if that is the case), inspection reports
- Description of the internal audit process, audit strategy, record of audits conducted (and backlog, if that is the case), audit reports
- Description of the data validation protocol
- Record of enforcement actions taken in cases of non-compliance, including fines and penalties imposed on leaseholders
- Policies on conflicts of interest, ethics, and independence
- Description of fraud and corruption detection and prevention controls
- Records of the information on oil and gas payments made available to the public as part of a transparency initiative
- Organizational charts, record of staff training, proof of independence for external experts, and so on
- Coordination agreements between responsible departments or agencies

Interviews: Interviews with key managers and staff in the organization(s) responsible for collecting oil and gas revenues can be valuable testimonial evidence in an audit of oil and gas revenues. Interviews of industry association members, relevant stakeholders, and representatives of other jurisdictions may also be useful, depending on the specific audit focus.

While testimonial evidence is usually considered weaker than documentary evidence, interviews can be useful to:

- confirm information obtained from other sources of evidence (thus strengthening the support for audit observations and conclusions),
- confirm the absence of something that was expected to exist,
- place documentary evidence in its proper context, and
- open new leads in an audit and identify further sources of evidence.

When testimonial evidence from an interview is to be used to support audit observations and conclusions, it is good practice to document the interview and to have the interviewee either approve the minutes or confirm in writing (by email or letter) the accuracy of the key statements intended to be used as evidence.

Testing of controls and IT systems: As explained in the [Planning Phase](#) section, public sector organizations must rely on a number of controls to ensure that the payments they receive from oil and gas companies for the extraction of oil and gas resources are accurate and complete. Given the importance of these controls to achieve this objective, it is likely that auditors will test a selection of controls during the examination phase of their audit of oil and gas revenues.

By doing a walkthrough of selected controls, auditors can document that controls have been put in place, but they generally need to do more testing to ascertain whether the controls are effective. This type of testing will often involve selecting a sample of transactions or using data mining and analysis techniques to detect anomalies in a large number of transactions. Testing the quality of datasets can also be a necessary audit procedure.

Depending on the nature and complexity of the IT systems used by responsible departments and agencies, audit teams may need the help of an IT expert to complete their audit procedures. This may be particularly useful when there is a highly automated royalty process in place. In such a case, an IT expert can review IT general controls and validate application controls for the calculation of royalties. A review of audit trail functions may also help auditors to identify higher risk areas.

Whatever control testing auditors decide to conduct, they should document all the steps they took as part of the process so that another auditor could replicate their work and arrive at the same conclusion.

Site visits: Site visits are key to understanding how things work in a jurisdiction. They give auditors a chance to meet many individuals who have direct knowledge of key processes and to observe first-hand the workings of important systems. Site visits can be even more valuable if an audit team is accompanied by an independent expert.

In terms of evidence, site visits can help auditors to map out processes in detail. They may also provide opportunities to test key controls and perform substantive tests of details. Finally, they are a good way to obtain testimonial and documentary evidence.

Challenges involved in auditing oil and gas revenues

In 2012, The International Organization of Supreme Audit Institutions (INTOSAI) surveyed supreme audit institutions' experience in auditing extractive industries. The survey identified many challenges in auditing extractive industries, including:

- the technical complexity of extractive industries,
- lack of knowledge of business about processes in the extractive industries,
- the need for capacity building and retention of specialized staff within audit offices, and
- mandate limitations.

Some of these challenges are discussed below, under the following categories:

- expertise,
- site visits, and
- access to information.

The INTOSAI Working Group on the Audit of Extractive Industries

In the 2012 INTOSAI survey, many audit institutions expressed a need for more knowledge of extractive industries and for a forum to exchange experiences auditing extractive industries. As a result, INTOSAI established a new [Working Group on Audit of Extractive Industries](#) (WGEI) to promote exchanges and to support the development of audit guidance and best practices. The WGEI held its first meeting in Uganda in 2014.

Expertise: The oil and gas industry is a complex, often heavily regulated sector. Auditors who intend to audit revenues from oil and gas extraction may need access to specialized knowledge and expertise to conduct their audit. Depending on the audit focus, a team may need the help of a tax or data-mining expert, an IT specialist, a lawyer, or an engineer.

However, finding an expert for an audit engagement may be difficult, especially if the field of expertise is very technical and if the sector is undergoing a period of rapid growth. The necessity for experts to be independent from oil and gas companies is challenging because most active experts have links with the industry. For this reason, auditors may consider hiring a retired expert as a consultant.

Another option is for an audit office to have one or more individuals with in-depth knowledge of oil and gas business processes on staff (or to train an individual to become a specialist in this field). The problem with this option is that these specialists will often be able to find better-paying jobs in the oil and gas industry. As a result, it may be difficult for an audit office to retain sufficient expertise on the oil and gas sector in-house.

Site visits: Performance auditors often develop their knowledge of business of a new area by conducting site visits to see relevant business activities first-hand and to meet knowledgeable staff and managers on the ground. With oil and gas extraction, there may be cases where this would be very costly or would involve complex logistics because oil and gas fields are often located in remote areas, far from cities and transportation hubs. There may also be security concerns or seasons in which weather conditions would make travel even more difficult.

Access to information: There may be some situations where auditors will have difficulty obtaining the required information to reach a conclusion on an audit criterion.

External auditors will not usually need to access the records and data of private oil and gas companies to conduct their audit, but should this need arise (for example, if auditors are seeking to assess the transfer pricing risk), they should not take for granted that private companies will collaborate with their audit, especially if the audit office does not have a clear legal mandate to access such information.

Another potential challenge related to access to information is when auditors decide to assess whether the decision to adopt a particular revenue framework or royalty regime was evidence-based. In such a case, it is possible that the required information will not be provided because it is considered to be subject to Cabinet confidence (meaning information for the members of the governing council of ministers only).

Finally, auditors may have trouble accessing information from other jurisdictions if they decide to benchmark their jurisdiction's practices against those in other jurisdictions. Indeed, it is possible that the extent of information they can obtain in their own jurisdiction because of their office's legal mandate will prove unattainable for other jurisdictions where their mandate does not apply. Because a fair benchmarking process requires comparing similar information from all selected jurisdictions, disparity in information quality and quantity may mean that no useful results can be drawn from the exercise.

[Back to Table of Contents](#)

Auditing Financial Assurances for Site Remediation

The Planning Phase



At this stage of the audit process, it is assumed that auditors have decided to include financial assurances for the remediation of oil and gas wells and facilities in their audit. However, they may not yet know exactly which programs and controls to audit, nor which audit objectives and criteria to use in their detailed audit plan.

This section of the Practice Guide is intended to help auditors answer these questions. It is organized according to the key actions and decisions that need to be made when conducting detailed planning for the audit:

- [Acquiring knowledge of business and assessing risk](#)
- [Drafting audit objectives](#)
- [Selecting audit criteria](#)

In jurisdictions where the government has opted to use a general remediation fund to manage liabilities associated with decommissioned oil and gas wells, the risks and controls will differ to some extent from situations where a financial assurance program is in place. These differences are discussed in the section on [Auditing Remediation Funds](#).

Finally, in jurisdictions where only a few large oil and gas companies operate under Production Sharing Agreements (PSAs) negotiated with the government, the rules governing the decommissioning of oil and gas wells may be defined in the PSAs themselves. In such cases, the auditors should use the PSA requirements as the basis for developing their audit plans.

Acquiring knowledge of business and assessing risk

Audit procedures typically require auditors to acquire knowledge of the organization and subject matter being audited and to prepare a risk-based audit plan.

In practice, this means that, once the decision has been made to audit financial assurances for site remediation, the audit team should start conducting research and interviewing officials in order to acquire (or further develop) a sound knowledge of business and an understanding of the risks facing the audited organizations. The information collected will be used to determine what the main risk areas are and where audit efforts should be directed.

In addition to information about the mandates and roles and responsibilities of the public sector organizations involved in collecting and managing financial assurances for the remediation of oil and gas wells and facilities, auditors can obtain information on three key subject areas:

- the fiscal and regulatory environment for oil and gas extraction in the jurisdiction under review, particularly with regard to decommissioning and site remediation;
- the structure of the industry in the jurisdiction – how many operating companies are there, how big are they and how many wells do they operate? (smaller companies have fewer resources and are more likely to go out of business, increasing the risk of new decommissioning liabilities for governments); and
- public sector policies and processes that pertain to assessing and collecting financial assurances for site remediation, as well as the resources available to implement relevant policies and programs.

While much of the information related to the first category will be found in legislation, regulations, government websites, and so on, obtaining information belonging to the other categories will likely require auditors to conduct a number of preliminary interviews. At this stage, auditors should be asking questions that do not require extensive research and file reviews to answer. Auditors typically address these more in-depth questions in the audit's examination phase, once the objective and focus of the audit have been clearly defined. However, an audit team may decide that it would benefit from using an independent expert early on in the audit if it feels that it does not have all the expertise it needs to assess key risks.

For each financial assurance program selected for audit, a number of areas can be examined, including:

- the design of the financial assurance program,
- the collection of financial assurances, and
- the internal controls in place to ensure the accuracy and completeness of payments.

Each of these areas is described in more detail below and some of the controls that could be audited under each area are highlighted.

Design of financial assurance program: To reduce the risk of inheriting financial liabilities from abandoned oil and gas extraction sites, many governments have adopted laws and regulations that create obligations for oil and gas leaseholders to plan for the decommissioning of their oil and gas wells early on in an extraction project and to provide government with sufficient financial assurances to cover the eventual clean-up costs should the sites be abandoned (after a bankruptcy, for example).

Different mechanisms exist for such purposes, but often governments require leaseholders to provide financial guarantees (cash, securities and bonds, letters of credit, certificates of deposit, or other type) to ensure that there will be sufficient resources in the future to cover remediation costs for their oil and gas wells and facilities. In some cases, oil and gas companies that have an excellent credit rating and a solid financial situation are allowed to self-insure.

Performance auditors can examine whether the design of the financial assurance program is adequate to ensure that the government is protected from inheriting further liabilities from sites that may be abandoned in the future. To achieve this, governments need to update their relevant regulations periodically to ensure that they still reflect best practices and that any fixed contribution amounts are updated to take into account:

- the actual costs of remediating oil and gas wells and facilities based on market conditions;
- new remediation technologies;
- changes in environmental or accounting standards; and
- the implications of recent land claims decisions, where relevant.

Table 14 includes examples of knowledge of business questions about the design of financial assurance programs that auditors can ask during the planning phase about the design and implementation of financial assurance programs. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 14 – Design of Financial Assurance Programs: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
Establishing the financial assurance program	<ul style="list-style-type: none"> ▪ Has the government established a financial assurance program to manage the financial risks that accrue from the remediation of oil and gas wells? ▪ Which laws, regulations, and policies provide the framework for collecting financial assurances for site remediation? When were these documents last updated? ▪ Are there regulations that define the requirements (standards) that leaseholders must meet when decommissioning oil and gas wells and associated facilities (the basis for estimating remediation costs)? ▪ Has the responsible organization determined the costs of various activities that would likely take place during a remediation project, to serve as a basis for assessing cost estimates provided by oil and gas companies?

Sub-topic	Knowledge of Business Questions
	<ul style="list-style-type: none"> ▪ Are there rules about how long a company can maintain an oil or gas well in a non-operational mode before it is finally capped and cleaned up? ▪ Do the laws and regulations define a required frequency of review for the adequacy of financial assurances? ▪ Do laws and regulations take into consideration recent land claim agreements (where relevant)? ▪ Do program rules require the funds submitted by industry to be held in trust?
Roles and responsibilities	<ul style="list-style-type: none"> ▪ Are there documented roles and responsibilities of the organizations responsible to manage the liabilities related to site remediation?
Clear rules and guidance	<ul style="list-style-type: none"> ▪ Is guidance provided to leaseholders on how to calculate their expected financial assurances? ▪ Is the guidance updated as necessary to reflect changes in applicable regulations and lessons learned from experience? When was the guidance last updated? ▪ Are changes in requirements communicated to leaseholders in a timely manner? ▪ Is there clear guidance to set out the circumstances in which the responsible organization may accept that a leaseholder self-insure?
Program reviews and updates	<ul style="list-style-type: none"> ▪ Are the remediation cost baselines that are used to establish the levels of financial assurances regularly reviewed and updated? When was the last review completed? ▪ When reference remediation costs are updated, is the adequacy of financial assurances held by the organization reassessed and corrective measures taken in a timely manner?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the design of the financial assurance program.

Auditors should consider including the design of the financial assurance program in their audit plan if their preliminary audit work indicates that:

- The laws and regulations supporting the creation of a financial assurance program are very old and do not reflect current industry practices.
- There are no rules about how long a company can maintain an oil or gas well in a non-operational state and statistics show that numerous wells have lain dormant for decades instead of being decommissioned and cleaned up.
- There are indications that the responsible organization is too permissive in allowing oil and gas companies to self-insure or is not conducting all the necessary checks before taking such decisions.
- Guidance for oil and gas companies about financial assurances does not reflect legislative or regulatory

changes.

- The remediation cost baselines that are used to establish the levels of financial assurances that should be provided by oil and gas companies are not regularly reviewed and updated.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include the design of the financial assurance program in their audit plan.

The collection of financial assurances: Auditors can also audit the collection of financial assurances and the administration of the program in place. This implies examining whether the responsible organization:

- has a complete and up-to-date list of leaseholders and their oil and gas well sites;
- ensures that it receives all remediation plans and financial assurances from leaseholders in a timely manner;
- has the necessary human resources and IT systems to carry out this work effectively and efficiently; and
- coordinates its activities with other organizations, where applicable.

Table 15 includes examples of knowledge of business questions about the collection of financial assurances that auditors can ask during the planning phase. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 15 – Collection of Financial Assurances: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
<p>Controls over the collection of financial assurances</p>	<ul style="list-style-type: none"> ▪ Is there a database of leaseholders that are expected to submit financial assurances? Is there a database of all oil and gas extraction sites in the jurisdiction? If so, are these databases regularly reviewed and updated? When was the last update completed? ▪ Is there a database of all legacy sites? Is this list regularly reviewed and updated? ▪ Is there an IT system to track financial assurances submitted by leaseholders? ▪ Are there systems and procedures to determine what is owed, to identify late reports and payments, and to ensure amounts owed are paid and letters of credit (or other guarantee) are still valid? ▪ Is there guidance for staff on how to collect and manage financial assurances, including managing late payments or submissions? ▪ Are there penalties or fines applicable in cases of non-compliance? Are these penalties or fines sufficient to change behaviours? Does the organization apply penalties or fines in cases of non-compliance? ▪ Is follow-up action promptly taken in cases of late payment or underpayment

Sub-topic	Knowledge of Business Questions
	<p>(above a certain percentage of the amount due)? Are penalties applied in practice?</p> <ul style="list-style-type: none"> ▪ Is the organization tracking its performance in assessing and collecting financial assurances? ▪ Does the organization prepare a report every year to provide assurance on the completeness of the financial assurances collected and the supporting remediation plans?
Staffing and training	<ul style="list-style-type: none"> ▪ Has the required number of staff necessary to handle financial assurances been determined? Are all required positions staffed? ▪ Does the current staff have the expertise necessary to review the adequacy of remediation plans and cost estimates? ▪ Are there challenges related to ensuring there is always sufficient qualified staff to handle financial assurances submissions? ▪ Is training provided to staff? ▪ Are there policies on conflicts of interest, ethics, and independence?
Coordination	<ul style="list-style-type: none"> ▪ Where there is more than one responsible organization, is there a formal coordination agreement in place (memorandum of understanding or other)? ▪ Are the roles and responsibilities of all parties clearly documented? ▪ Is there an agreement on what information needs to be shared between organizations to ensure effective environmental monitoring of sites?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the administration of the financial assurance program.

Auditors should consider including the administration of the financial assurance program in their audit plan if their preliminary audit work indicates the following:

- The database of leaseholders and their oil and gas wells is not regularly updated.
- There is no guidance for staff on how to collect and manage financial assurances.
- There is no periodic review of received assurances to ensure they are still valid.
- Penalties and fines are not applied as intended in cases of non-compliance with the rules of the financial assurance programs.
- The responsible organization does not report annually on the amount of financial assurances it has collected for the purpose of safeguarding the government against liabilities for remediation of oil and gas extraction sites.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only

after conducting this work will auditors be able to decide whether to include the administration of the financial assurance program in their audit plan.

Internal controls over financial assurances: The value of the financial assurances that need to be provided by leaseholders to cover the costs of future remediation activities for an extraction site will vary over time for a number of reasons, which may include the following:

- Early remediation work has already started, reducing future liabilities.
- New remediation technologies and techniques become available or the costs of current technologies and techniques change.
- Evolving environmental standards and evolving land claim decisions may affect the required level of remediation.
- Significant changes are made to decommissioning plans.
- The oil or gas reserve estimate has been revised, changing revenue expectation and the expected capacity of a leaseholder to pay for remediation costs.

To ensure that governments hold sufficient financial assurances for site remediation, the responsible organizations need to review all the decommissioning plans they receive from leaseholders and to verify the amounts that should be provided as guarantee.

For further assurance, governments can monitor leaseholders and their oil and gas wells to ensure that site information provided by oil and gas companies is still accurate and up to date. (A company's operational plans may have changed significantly over time). However, there can be many thousands of oil and gas wells in a jurisdiction and it is unlikely that government inspectors (or hired consultants) can visit each site every year. For this reason, governments need to have risk-based inspection strategies to target their limited resources at higher risk sites.

Once a leaseholder remediates a site, the government can return the financial guarantee to the leaseholder. However, there should be controls in place to ensure that sites have been remediated in accordance with applicable standards. Review of remediation reports and site inspections are two control mechanisms that can be relied on. In the absence of such controls, there is a risk that governments may end up being liable for the costs of cleaning up sites that were not adequately remediated.

Auditors working on an audit of financial assurances for the remediation of oil and gas extraction sites can therefore audit whether governments:

- have established adequate controls to ensure they are holding sufficient financial assurances to cover expected remediation costs in the future and
- have adequate controls to ensure that they release financial assurances only when oil and gas production sites have met all applicable remediation standards.

Table 16 includes examples of knowledge of business questions that auditors can ask about internal controls over financial assurances during the planning phase. Examples of related audit [objectives](#) and [criteria](#) are provided in later sections of the Practice Guide.

Table 16 – Internal Controls Over Financial Assurances: Examples of Knowledge of Business Questions

Sub-topic	Knowledge of Business Questions
<p>Completeness of information and accuracy of cost estimates</p>	<p>Remediation plan validation</p> <ul style="list-style-type: none"> ▪ Are resource extraction companies required to provide supporting evidence or independent verification of their remediation cost estimates? ▪ Are the remediation plans provided by leaseholders reviewed by a specialist to confirm reasonability and compliance with relevant requirements (regulations, standards, industry good practices, or contract condition)? If so, are those reviews documented? ▪ Is there guidance and/or standards on how to validate cost estimates provided by leaseholders? ▪ Are financial guarantees recalculated based on data provided? ▪ Are there time standards for completing reviews and data validation? ▪ Is there a backlog of reviews and recalculations to complete? <p>Site inspections</p> <ul style="list-style-type: none"> ▪ Are periodic site inspections conducted to monitor site status and validate information provided in remediation plans? ▪ Is there a risk-based inspection strategy? ▪ Are all planned inspections conducted? Is there an inspection backlog? ▪ Do inspections include sample collection and testing or just a physical inspection of the sites? ▪ Is timely action taken to follow-up on inspection results that indicate non-compliance or other issues? ▪ At the end of the remediation process for a specific site, is a site inspection conducted before issuing a remediation certificate? <ul style="list-style-type: none"> ▪ Are there sufficient qualified inspectors on staff to conduct all planned inspections? ▪ Are the results of inspections documented? <p>Audits</p> <ul style="list-style-type: none"> ▪ Have internal audits of the financial assurance program been conducted? ▪ Have recommendations for improvement been implemented?

Sub-topic	Knowledge of Business Questions
Staffing and training	<ul style="list-style-type: none"> ▪ Has the required number of inspectors necessary to conduct all planned inspections been determined? Are all required inspector positions staffed? ▪ Is specialized training provided to inspectors? ▪ Is there a hiring and retention strategy for inspectors? ▪ Is there a staff rotation policy to ensure that inspectors do not become too closely involved with individual cases?
Coordination	<ul style="list-style-type: none"> ▪ Where there is more than one responsible organization, is there a formal coordination agreement in place (memorandum of understanding or other)? ▪ Are the roles and responsibilities of all parties clearly documented?

Once auditors have obtained answers to their knowledge of business questions, they can better assess the risks related to the internal controls over the financial assurance program.

Auditors should consider including the internal controls over of the financial assurance program in their audit plan if their preliminary audit work indicates the following:

- Remediation plans submitted by oil and gas companies are not reviewed by an internal or independent specialist.
- There is no guidance to explain to staff how to validate the remediation cost estimates provided by oil and gas companies.
- Site visits are not conducted periodically to assess whether remediation plans still reflect the reality of activities on oil and gas extraction sites.
- Site inspections are not conducted in a timely manner and there is an inspection backlog.
- No internal audit of the financial assurance program has been conducted.

This list of potential audit issues is indicative, not exhaustive. It is the responsibility of audit teams to review and analyze the information they collect in the planning phase in order to identify and assess significant risk areas. Only after conducting this work will auditors be able to decide whether to include the internal controls over the financial assurance program in their audit plan.

Drafting audit objectives

All performance audits need clearly stated objectives that are worded in a manner that allows auditors to conclude against them. Audit objectives should be realistic and achievable and give sufficient information to audited organizations about the focus of the audit.

An audit can have one or several objectives depending on its breadth. Office practice will also influence the number of objectives and whether or not sub-objectives are used. (Some audit offices never use sub-objectives). Sub-objectives can be included in audit plans (for example, one for each line of enquiry), but auditors who decide to do so will still be expected to conclude on their main audit objective(s).

The objective of an audit that will look at the financial assurances for the remediation of oil and gas wells and facilities will depend on whether that is the sole focus of the audit. If the audit will broadly examine the development of the sector, including remediation, then a general objective will be appropriate. For example:

- *To determine whether the responsible organizations have taken effective measures to ensure that shale gas extraction activities are developed in accordance with the government policy and objectives.*

This objective could be supported by sub-objectives related to the main areas included in the audit. One of these sub-objectives could be about financial assurances for the remediation of oil and gas wells:

- *To determine whether responsible organizations have systems for obtaining and managing financial assurances that reflect risks and minimize costs.*

If the audit is strictly concerned with the environmental risks of oil and gas wells, then the objective can be focused on this aspect while still being broad enough to enable auditors to examine the financial aspects of this subject area, including liabilities for the remediation of oil and gas wells and facilities. For example, the objective could be:

- *To determine whether the department's oversight mechanisms ensure that shale gas extraction activities are conducted in ways that minimize their impact on the environment and that take into account the public interest.*

In this case, a sub-objective on financial assurances could be added to support the main objective:

- *To determine whether the department has established an effective program to manage the financial risks associated with the remediation of shale gas wells and related facilities.*

If the audit is strictly about the financial assurances for the remediation of oil and gas wells, then the sub-objective above could serve as the main audit objective. This objective could in turn be supported by sub-objectives:

- *To determine whether the department has established adequate controls to ensure it is holding sufficient financial assurances to cover potential remediation costs in the future.*
- *To determine whether the department ensures that it releases financial assurances to leaseholders only when oil and gas production sites have met all applicable remediation standards.*

Selecting audit criteria

Audit criteria represent the standards that audited organizations are expected to meet. Audit criteria are a key contributor to an audit's strength and potential impact. Audit procedures focus on determining whether criteria are met or not met. Suitable criteria are relevant, complete, reliable, neutral, and understandable.

Finding suitable criteria is a challenge for any performance audit, especially where there is no recognized source of accepted criteria. There is no such recognized source of criteria for auditing financial assurance programs for the remediation of oil and gas extraction sites.

The examples of criteria presented in **Tables 17** and **18** have been compiled from published audits and modified to be uniform in style. Where there were gaps, criteria were added. The list of criteria was then discussed by members of the Advisory Group created to support the development of this Practice Guide. Improvements were made as necessary based on their comments. Finally, all the audit offices represented by the Canadian Council of Legislative Auditors had an opportunity to comment on the proposed criteria before the publication of the Practice Guide (comments were also received from some members of the INTOSAI Working Group on the Audit of Extractive Industries).

The criteria in **Tables 17** and **18** are not exhaustive and can be modified according to the specific needs of auditors. They can also be used as sub-criteria in cases where it is possible to draft a criterion with a broader coverage. The tables provide sample audit criteria in the following areas:

- [Design of the financial assurance program](#)
- [Administration of financial assurances \(including internal controls\)](#)

Table 17 – Examples of Audit Criteria for Auditing the Design of Financial Assurance Programs for the Remediation of Oil and Gas Extraction Sites

Sub-topic	Audit Criteria
Establishing the financial assurance program	<ul style="list-style-type: none"> ▪ The financial assurance program was established after potential options were evaluated using evidence-based methods. ▪ Industry and other stakeholders were consulted as part of the policy-making process. ▪ The rationale for final decisions has been documented. ▪ Remediation cost baselines based on current remediation technologies have been established to serve as a reference for reviewing remediation plans and financial assurances provided by oil and gas companies. ▪ The financial assurance program reflects good practices and protects the government from inheriting responsibility for new, unfunded liabilities arising from abandoned extraction sites. ▪ Roles and responsibilities for assessing and collecting financial assurances for site remediation are clearly defined and documented. ▪ The program design includes a right to audit clause.
Clear rules and guidance	<ul style="list-style-type: none"> ▪ Regulations, policies, and directives clearly set out oil and gas site remediation requirements. ▪ The responsible organization has provided guidance to the industry on how and when leaseholders should prepare decommissioning plans and provide financial assurances for site remediation. ▪ The responsible organization regularly keeps leaseholders informed of changes to

Sub-topic	Audit Criteria
	site remediation and financial assurance requirements.
Program reviews and updates	<ul style="list-style-type: none"> ▪ The financial assurance program is reviewed periodically and modified as needed to take into account new remediation technologies, updated remediation cost estimates, and other relevant factors.

Table 18 – Examples of Audit Criteria for Auditing the Administration of Financial Assurances for the Remediation of Oil and Gas Extraction Sites

Sub-topic	Audit Criteria
Controls over financial assurances	<ul style="list-style-type: none"> ▪ The organization has a complete and up-to-date list of all oil and gas wells in its jurisdiction and their status. ▪ The organization ensures that companies submit their financial assurances and related data in a timely manner and follows up on late submissions. ▪ To encourage compliance, the organization imposes meaningful penalties on leaseholders that do not provide financial assurances and supporting documents on a timely basis. ▪ When necessary, the organization exercises its legal rights to obtain the information it requires from leaseholders. ▪ Automated systems are in place to track remediation plans and financial assurances submitted for each extraction site. ▪ The organization reviews remediation plans and related cost estimates to assess their completeness, accuracy, and validity. ▪ The organization ensures that remediation plans are reviewed for completeness and quality by qualified, independent experts (internal or external) and revised as needed. ▪ The organization has a process in place to communicate deficiencies found in the remediation plans, corrective action to be taken, and the expected timelines for completing corrective action. ▪ The organization ensures that follow-up on recommended corrective actions is done in a timely manner. ▪ The organization regularly reviews the status of non-cash securities to ensure they are still valid. ▪ The organization ensures that financial assurances are only returned to leaseholders after it has been verified that all remediation requirements have been met. ▪ In cases where the organization accepts that a company self-insure, there is a process in place to regularly review the company's global financial health. ▪ The organization has systems and processes for promoting the consistent

Sub-topic	Audit Criteria
	<p>application of the financial assurance program, including providing information to oil and gas companies on the interpretation of legislation and regulation, and the results of recent judgments.</p>
<p>Staffing and training</p>	<ul style="list-style-type: none"> ▪ The organization has identified its staffing requirements and ensured that it has sufficient qualified personnel to process financial assurance files in a timely manner. ▪ The organization has sufficient qualified personnel to ensure that all site inspections are conducted in a timely manner. ▪ Staff receive adequate training in a timely manner to ensure they can perform their duties effectively. ▪ Systems and processes are in place to ensure that staff (especially inspectors) and contractors are independent from oil and gas companies. ▪ Strategies are in place to reduce staff turnover and retain skilled staff in order to ensure that there is always sufficient staff to process and review financial assurance files.
<p>Coordination</p>	<ul style="list-style-type: none"> ▪ Responsible organizations have clearly defined their respective roles and responsibilities. ▪ Responsible organizations have clearly identified what information they need to share with each other. ▪ The responsible organizations coordinate their activities to ensure an effective and efficient oversight over financial assurances for site remediation.

Auditing remediation funds

Financial assurance programs are one way to manage the liabilities associated with decommissioned oil and gas wells and facilities. Another way is to establish a general remediation fund to which oil and gas companies contribute and that is used to clean up abandoned sites, both legacy sites and any site that becomes orphaned due to a company going bankrupt.

There are some key differences between remediation funds and financial assurance programs:

- The contributions to a remediation fund are not linked to any particular site (for example, the contribution of one company may be used to clean up the site of another company.)
- There is no need to return contributions to companies once sites have been remediated (by definition, the sites being remediated with fund money are abandoned and have become the government's responsibility).
- The financial risks do not rest at the same level. In a financial assurance program, the risk is not having sufficient guarantee to ensure that a specific site will be properly remediated, whereas in a remediation fund, the risk is at the aggregate level of all sites (that is, there is a risk of not collecting enough funds to remediate all abandoned sites).

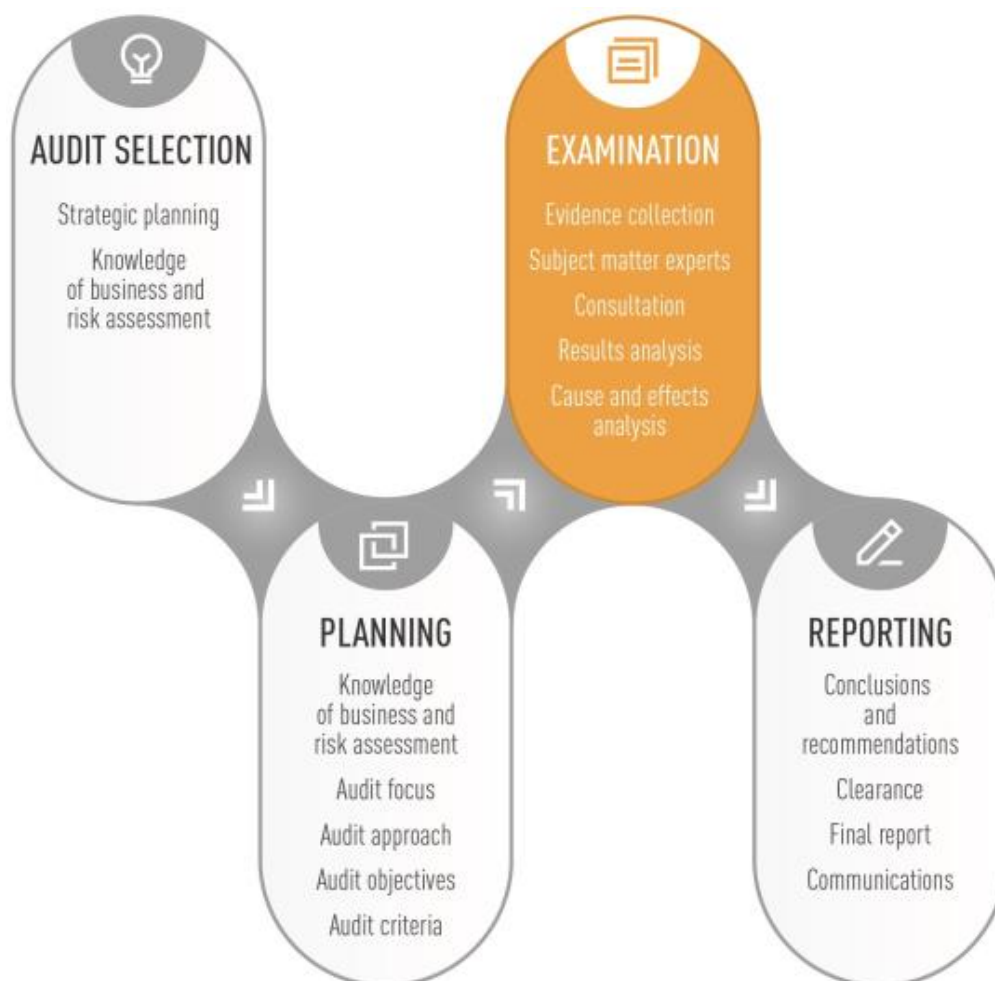
These differences imply that an audit of a remediation fund will not have the same focus as an audit of a financial assurance program. Questions on the design of the remediation funds will be important because how a government determines how much companies should contribute to a fund is a crucial factor in ensuring that enough funds are collected to clean up abandoned sites. The assessment of liabilities at the aggregate industry level will therefore be a key process to look at during the audit (as opposed to the assessment of each specific site, which matters more in a financial assurance program). Accordingly, auditors should consider including a criterion in their audit plan to cover this issue.

Once a government has determined how much money oil and gas companies should contribute to a remediation fund, collecting contributions is rather simple compared with collecting financial assurances. This is because there is less need for a regular case-by-case review of remediation costs for each site and there is no need to check that financial assurances are still valid and up to date.

Performance auditors who decide to audit the design and implementation of a remediation fund for oil and gas wells and facilities can use the guidance provided for financial assurances in the previous sections. They can select the [questions](#) and [criteria](#) that are also relevant for remediation funds and modify them or add to them as necessary to better fit the characteristics of remediation funds.

[Back to Table of Contents](#)

The Examination Phase



During the examination phase of a performance audit, audit teams must conduct procedures that will yield sufficient appropriate evidence to:

- determine whether audit criteria are met,
- conclude on audit objectives, and
- document and support these conclusions.

During the planning phase, auditors carefully consider which audit tests and procedures to include in their detailed audit program and make decisions based on (1) the type of evidence they will require to reach conclusions against their audit criteria and (2) an assessment of the time, expertise, and resources they would require to conduct each test or procedure. Ultimately, the audit team has to plan audit procedures that will provide sufficient and appropriate evidence while respecting the audit's budget.

However, planning and conducting audit procedures may not always be easy and straightforward in an audit of financial assurances for site remediation. From mandate limitations to finding the necessary expertise, performance auditors may have to deal with a number of challenges before they can obtain all the information they seek and conclude on their audit objective(s).

This section of the Practice Guide covers:

- [Evidence sources and audit tests](#) for audits of financial assurances
- [Challenges](#) involved in auditing financial assurances for site remediation

Evidence sources and audit tests

Documentary, testimonial, physical, and analytical evidence can all play a role in audits of financial assurances for site remediation. The main sources of evidence that will be useful in this context are:

- a review of relevant documents,
- interviews,
- testing of controls and IT systems, and
- site visits.

Review of relevant documents: By their nature, performance audits rely heavily on documentary evidence, and audits of financial assurances are no exception. Auditors need to consider everything from evidence of the rules that government organizations and oil and gas companies have to meet to evidence that controls have been put in place and are functioning as intended. Documentation needs to be gathered, reviewed, and analyzed by auditors, then added to the audit file if it is deemed relevant to support audit observations and conclusions.

Table 19 provides many examples of documents that may prove useful as audit evidence in an audit of financial assurances.

Table 19 – Examples of Documentary Evidence that May Be Useful in an Audit of Financial Assurances for Site Remediation

Documents
<ul style="list-style-type: none"> ▪ Laws, regulations, and policies that govern the oil and gas sector, including financial assurance requirements ▪ Descriptions of financial assurance programs ▪ Reports on financial assurance programs, including audits and evaluation reports ▪ Process maps and narratives ▪ Risk analysis of where there may be underestimation of potential future liabilities for site remediation ▪ List of oil and gas wells in the jurisdiction, list of leaseholders ▪ Guidance to the industry on how to calculate financial assurances ▪ Communications to the industry about changes in laws, regulations, or processes ▪ Guidance to staff on how to process and review financial assurances provided by oil and gas companies ▪ Description of the process used to review the accuracy and completeness of the remediation plans and cost estimates provided by oil and gas companies ▪ Description of the site inspection process, inspection strategy, record of inspections conducted (and backlog, if that is the case), inspection reports ▪ Record of fines and penalties imposed on leaseholders in relation to the submission of remediation plans or

Documents

- payments
 - Record of the periodic review of financial assurances held by the responsible organization to ensure they are still valid and sufficient to cover potential future liabilities
 - Policies on conflicts of interest, ethics, and independence
 - Organizational charts, record of staff training, proof of independence for external experts, and so on
 - Coordination agreements between responsible departments or agencies

Interviews: Interviews with key managers and staff in the organization(s) responsible for collecting and managing financial assurances can be valuable testimonial evidence in an audit of financial assurances for site remediation. Interviews of relevant stakeholders and industry members may also be useful, depending on the specific audit focus.

While testimonial evidence is usually considered weaker than documentary evidence, interviews can be useful to:

- confirm information obtained from other sources of evidence (thus strengthening the support for audit observations and conclusions),
- confirm the absence of something that was expected to exist,
- place documentary evidence in its proper context, and
- open new leads in an audit and identify further sources of evidence.

When testimonial evidence from an interview is to be used to support audit observations and conclusions, it is good practice to document the interview and to have the interviewee either approve the minutes or confirm in writing (by email or letter) the accuracy of the key statements intended to be used as evidence.

Testing of controls and IT systems: As explained in the [Planning Phase](#) section, public sector organizations must rely on a number of controls to ensure that the financial assurances they receive from oil and gas companies for site remediation are accurate and complete. Given the importance of these controls to achieve this objective, it is likely that auditors will test a selection of controls during the examination phase of their audit of financial assurance programs.

By doing a walkthrough of selected controls, auditors can document that controls have been put in place, but they will generally need to do more testing to ascertain whether the controls are effective. This type of testing will often involve selecting a sample of transactions or using data mining and analysis techniques to detect anomalies in a large number of transactions. Testing the quality of datasets can also be a necessary audit procedure.

Depending on the nature and complexity of the IT systems used by responsible departments and agencies, audit teams may need the help of an IT expert to complete their audit procedures. In such a case, an IT expert can review IT general controls and validate application controls for the calculation of financial assurances.

Whatever control testing auditors decide to conduct, they should document all the steps they took as part of the process so that another auditor could replicate their work and arrive at the same conclusion.

Site visits: Site visits of oil and gas extraction sites or of the regional offices of an audited organization are key to understanding how things work in a jurisdiction. They give auditors a chance to meet many individuals who have direct knowledge of key processes and to observe first-hand the workings of important systems. Site visits can be even more valuable if an audit team is accompanied by an independent expert.

In terms of evidence, site visits can help auditors to map out processes in detail. They may also provide opportunities to test key controls and perform substantive tests of details. Finally, they are a good way to obtain testimonial and documentary evidence.

Challenges involved in auditing financial assurances for site remediation

In 2012, the International Organization of Supreme Audit Institutions (INTOSAI) surveyed supreme audit institutions' experience in auditing extractive industries. The survey identified many challenges in auditing extractive industries, including:

- the technical complexity of extractive industries,
- lack of knowledge of business processes in the extractive industries,
- the need for capacity building and retention of specialized staff within audit offices, and
- mandate limitations.

These and other challenges are discussed below, and include:

- expertise,
- site visits, and
- access to information.

The INTOSAI Working Group on the Audit of Extractive Industries

In the 2012 INTOSAI survey, many audit institutions expressed a need for more knowledge of extractive industries and for a forum to exchange experiences auditing extractive industries. As a result, INTOSAI established a new [Working Group on Audit of Extractive Industries](#) (WGEI) to promote exchanges and to support the development of audit guidance and best practices. The WGEI held its first meeting in Uganda in 2014.

Expertise: The oil and gas industry is a complex, often heavily regulated sector. Auditors who intend to audit financial assurances for site remediation may need access to specialized knowledge and expertise to conduct their audit. Depending on the audit focus, a team may need the help of an engineer, a securities specialist, a lawyer, or a data-mining expert.

However, finding an expert for an audit engagement may be difficult, especially if the field of expertise is very technical and if the sector is undergoing a period of rapid growth. The necessity for experts to be independent from oil and gas companies is challenging because most active experts will have links with the industry. For this reason, auditors may consider hiring a retired expert as a consultant.

Another option is for an audit office to have one or more individuals with in-depth knowledge of oil and gas business processes on staff (or to train an individual to become a specialist in this field). The problem with this option is that these specialists will often be able to find better-paying jobs in the oil and gas industry. As a result, it may be difficult for an audit office to retain sufficient expertise on the oil and gas sector in-house.

Site visits: Performance auditors often develop their knowledge of business of a new area by conducting site visits to see relevant business activities first-hand and to meet knowledgeable staff and managers on the ground. With oil and gas extraction sites, there may be cases where this would be very costly or would involve complex logistics because oil and gas fields are often located in remote areas, far from cities and transportation hubs. There may also be security concerns or seasons in which weather conditions would make travel even more difficult.

Access to information: There may be some situations where auditors will have difficulty obtaining the required information to reach a conclusion on an audit criterion.

Auditors will not usually need to access the records and data of private oil and gas companies to conduct their audit, but should this need arise, they should not take for granted that private companies will collaborate with their audit, especially if the audit office does not have a clear legal mandate to access such information.

Another potential challenge related to access to information is when auditors decide to assess whether the decision to adopt a particular financial assurance program was evidence-based. In such a case, it is possible that the required information will not be provided because it is considered to be subject to Cabinet confidence (meaning information for the members of the governing council of ministers only).

Finally, auditors may have trouble accessing information from other jurisdictions if they decide to benchmark their jurisdiction's practices against those in other jurisdictions. Indeed, it is possible that the extent of information they can obtain in their own jurisdiction because of their office's legal mandate will prove unattainable for other jurisdictions where their mandate does not apply. Because a fair benchmarking process requires comparing similar information from all selected jurisdictions, disparity in information quality and quantity may mean that no useful results can be drawn from the exercise.

The Reporting Phase



During the reporting phase of a performance audit, auditors produce a report that presents their audit observations and conclusions. Audit reports vary considerably in scope and nature. In addition, the formats and writing styles of performance audit reports are specific to individual audit offices. As a result, there is no standard way to present audit findings.

However, performance auditors can apply some common principles and good practices to improve the readability and impact of their audit reports. This section of the Practice Guide discusses:

- the use of diagrams and charts to provide [context](#) information in audit reports on oil and gas revenues and financial assurances and
- good practices for drafting effective [audit recommendations](#).

The Practice Guide does not provide guidance on report format and writing styles.

Setting the Context

When writing the introduction to an audit report on oil and gas revenues or financial assurances, auditors should clearly state why they carried out the audit and explain why the revenues or programs they audited are important.

Doing so will provide an answer to the “so what?” question that readers might pose and will let the readers know why they should care about the audit topic.

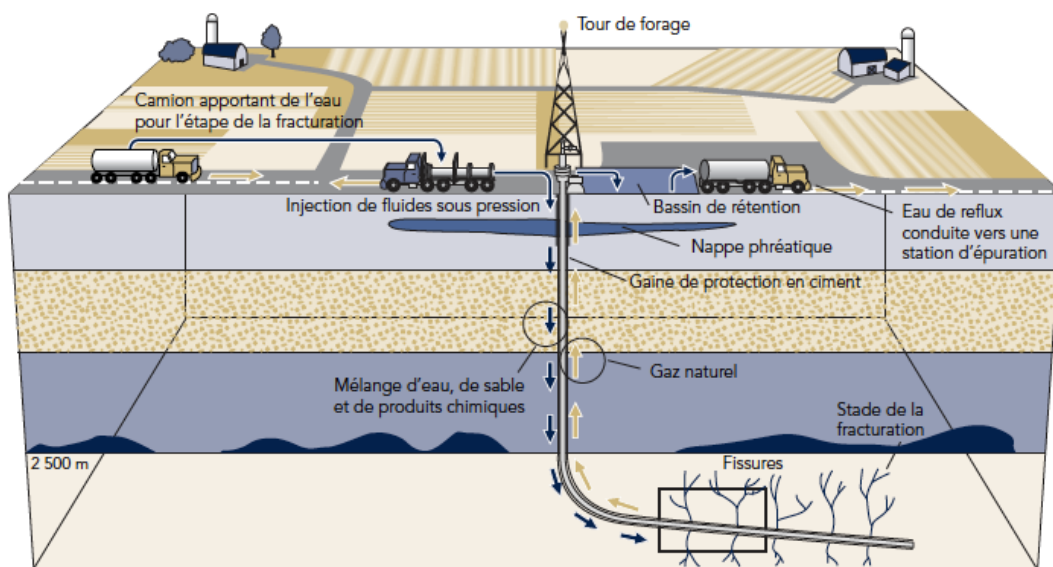
The front end of the report should also provide sufficient context to enable the readers to fully understand the report’s audit findings. Depending on the breadth of the audit, this may include providing context on:

- how a particular oil and gas resource is extracted (see **Figure 7** for an example),
- the relative importance and variation of each revenue source over time (see **Figures 8** and **9** for examples),
- the risks associated with revenue collection (see **Figure 10** for an example), or
- the geographic location of oil and gas wells in a jurisdiction (see **Figure 11** for an example).

By using easy-to-understand charts and diagrams, as in the examples from published audits in **Figures 7** to **11**, auditors can effectively present useful context without using too many words. Using charts and diagrams will also break the text and make the report more visually appealing and easier to read.

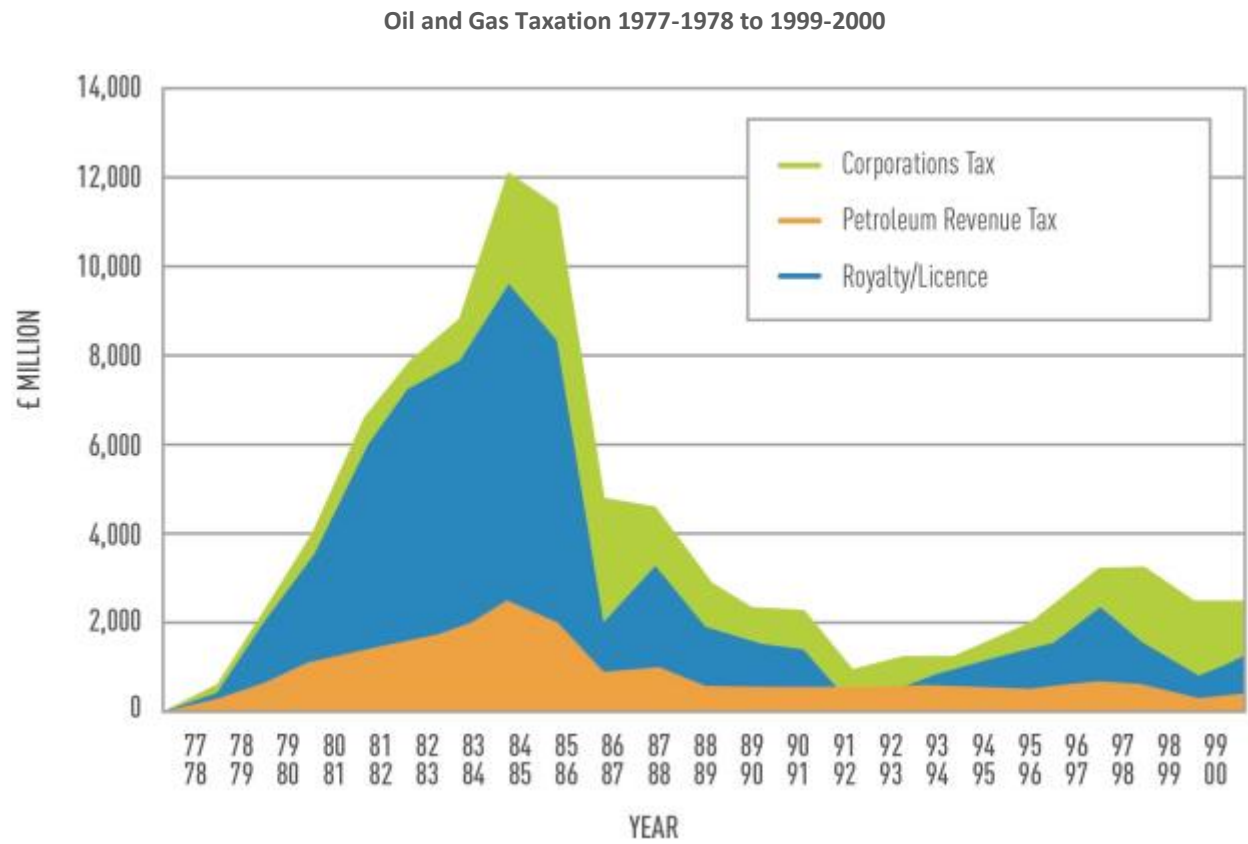
However, preparing good charts and diagrams requires some planning: success will be more likely if auditors start thinking about presentation formats and the necessary data early in the audit. Waiting for the reporting phase to identify the data required for a chart or diagram may not leave enough time for auditors to obtain reliable information and still meet reporting deadlines. Auditors should also remember that information used in charts and graphs must be subjected to rigorous quality assurance in the same way as other types of audit evidence.

Figure 7 – Example of a Diagram Showing How Natural Gas Is Extracted From the Ground Using the Hydraulic Fracturing Technique



Source: Vérificateur général du Québec (Office of the Auditor General of Québec) (2011). *Gestion gouvernementale de l'exploration et de l'exploitation des gaz de schiste* (government management of shale gas exploration and production)

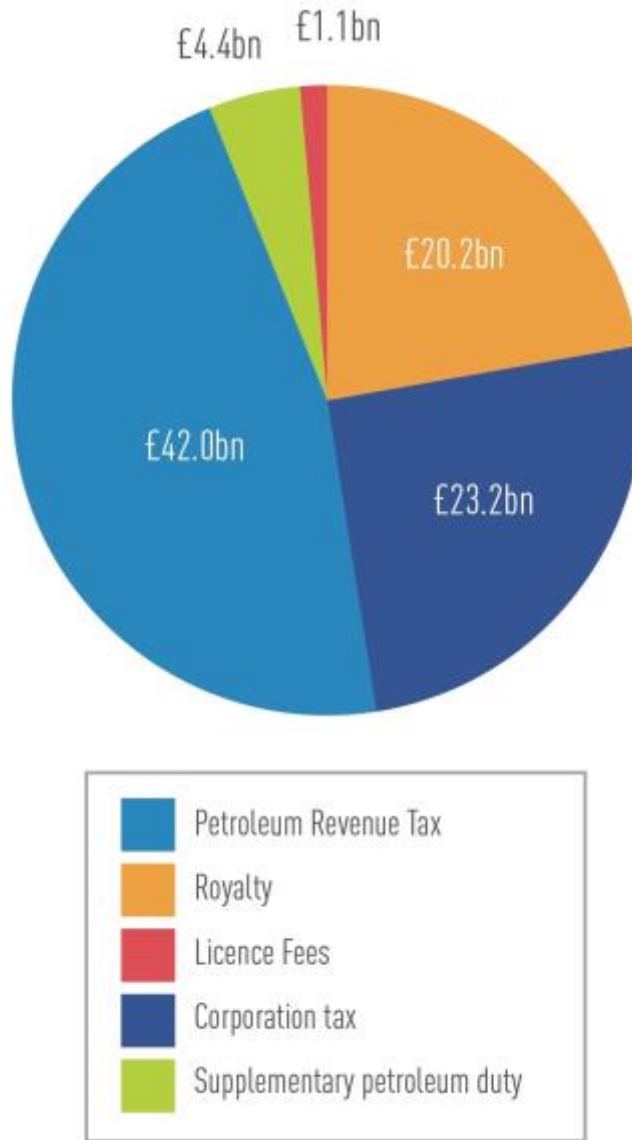
Figure 8 – Example of a Chart Showing the Evolution of Oil and Gas Taxation Revenue Over Time



Source: Adapted from United Kingdom National Audit Office (2000). *Inland Revenue – Petroleum Revenue Tax*.

Figure 9 – Example of a Chart Showing the Relative Importance of Different Revenue Streams Over a Period of Time

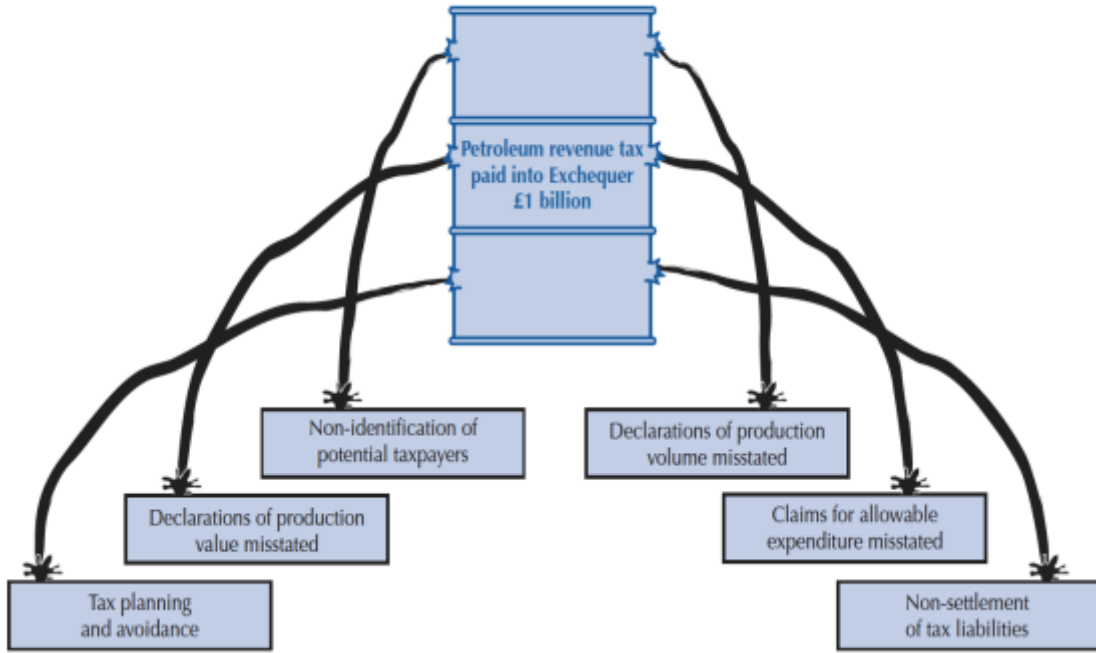
Taxation on UK Oil and Gas Production 1964-1965 to 1999-2000



Source: Adapted from United Kingdom National Audit Office (2000). *Inland Revenue – Petroleum Revenue Tax*.

Figure 10 – Example of a Diagram Showing the Risks Associated with the Collection of Oil and Gas Revenues

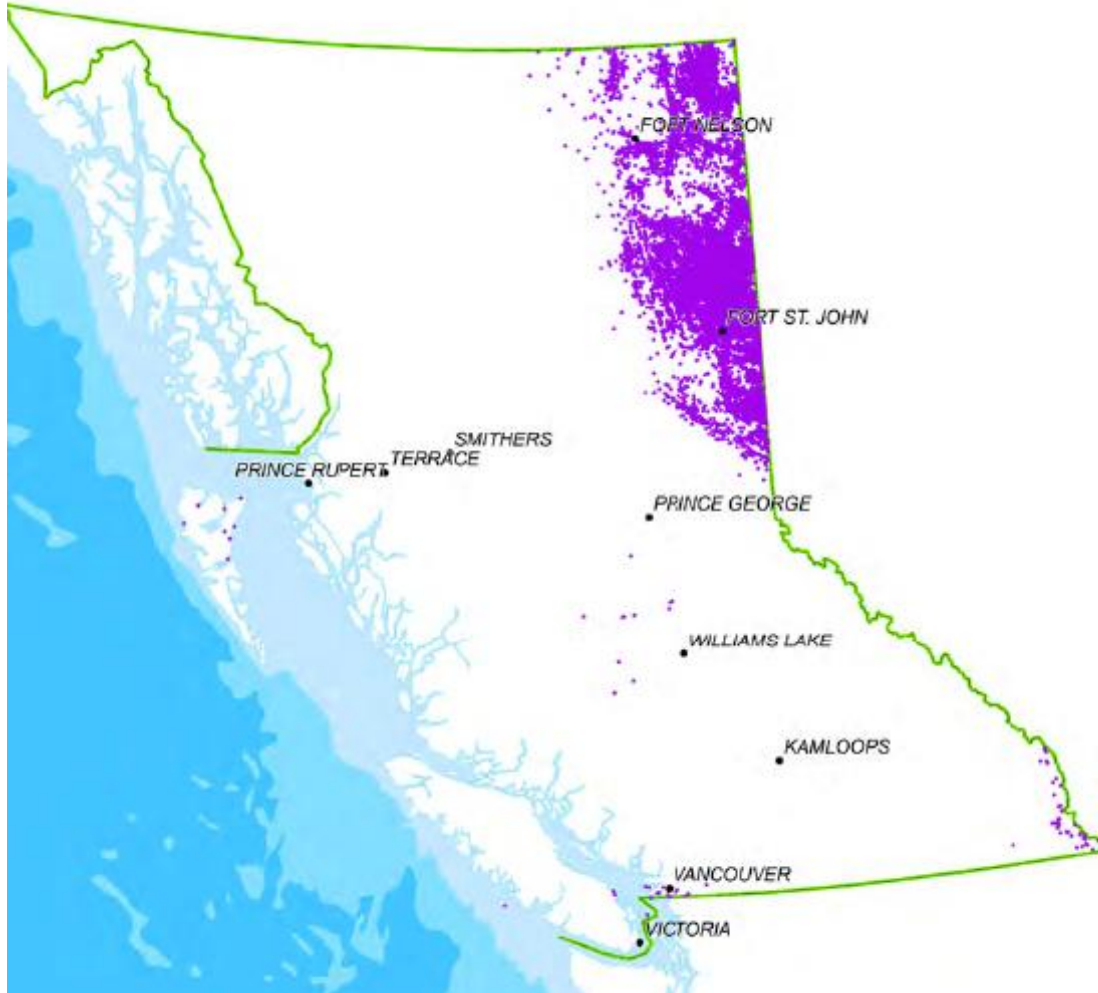
1 Risks associated with the administration of petroleum revenue tax



Source: United Kingdom National Audit Office (2000). *Inland Revenue – Petroleum Revenue Tax*.

Figure 11 – Example of a Map Showing Where Oil and Gas Wells Are Located in a Jurisdiction

Location of Oil and Gas Wells in British Columbia



Source: Office of the Auditor General of British Columbia (2009). *Oil and Gas Site Contamination Risks: Improved Oversight Needed*.

Drafting Recommendations

Drafting effective recommendations is a challenging task that requires much thought, discussion, and professional judgment. When drafting a recommendation, auditors can ask themselves the following questions:

- Is the recommendation addressed to the right organization (that is, the one that can actually implement it and make change happen)?
- Is the recommendation aimed at the root cause of the issue or at its symptoms? (See our [discussion paper on Root Cause Analysis](#) for guidance on this topic.)
- Does the recommendation clearly identify the risk(s) being addressed?
- Is the recommendation consistent with the audit observations?
- What is the cost and feasibility of implementing the proposed action? Are there alternative courses of remedial actions that would be easier to implement or be more affordable?
- What would be the impact on results, both positive and negative, if the recommendation were adopted?
- Could successful implementation of the recommendation be reasonably determined in a follow-up audit?

Furthermore, auditors can inform their decisions on audit recommendations by seeking the audited organization's views on the actions that would be necessary to correct the identified deficiencies. By discussing audit recommendations with audited organizations before completing audit reports, auditors can increase the likelihood that their recommendations will be implemented and will lead to positive change.

[Back to Table of Contents](#)

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[Back to Table of Contents](#)

Glossary

Audit conclusion

An informed judgment made by an auditor based on sufficient and appropriate audit evidence.

Audit focus

The breadth and depth of an audit, the risk areas, and the issues selected. Because different audit offices use the term “audit scope” in different ways, the Practice Guide avoids this word and instead uses “audit focus” to refer to the depth and breadth of an audit.

Audit observation

The outcome of an objective evaluation of audit evidence against selected audit criteria.

Audit program

A detailed outline of the audit work to be undertaken during the audit examination phase to gather sufficient and appropriate evidence. Each audit activity outlined in the program includes the applicable criteria to be used and the audit steps, tasks, resources, and time required to complete the work.

Audit recommendation

A measurable statement for corrective action made by the auditor and addressed to the audited organization. Recommendations must address the causes of deficiencies identified in audit reports.

Auditability

The ability to carry out an audit in accordance with professional standards and internal audit policies. Although some areas may be significant, they may not be auditable for the following reasons:

- the audit team does not have or cannot acquire the required expertise,
- the selected area is undergoing significant and fundamental change,
- suitable criteria or approaches are not available to assess performance, or
- the information or evidence required is not available or cannot be obtained efficiently.

Controls

The policies and procedures designed, put in place, and operated within an organization to mitigate the risks that threaten the achievement of the organization’s objectives.

Corruption

An abuse of public power, authority, trust, and resources for private or political gain. Corruption happens through the offering, giving, receiving, or soliciting, directly or indirectly, of anything of value to influence improperly the actions of another party.

Decommissioning

The action of closing down an extraction site and making it inoperative. This may involve dismantling all the equipment and facilities on site and decontaminating the soil and waters in accordance with regulatory standards.

Environmental liability

An obligation based on the principle that a polluting party should pay for any and all damage caused to the environment by its activities.

Financial assurance

A guarantee held in trust by a government to ensure that the remediation work outlined in a site closure plan is successfully performed, even in the event that the proponent of the project faces financial or legal troubles. The financial assurance should be equal to the estimated cost of the planned remediation work.

Fraud

An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

Oversight

The responsibility to review, monitor, and supervise public sector organizations and their policies, plans, programs, and projects, to ensure that they are achieving expected results and are in compliance with applicable policies, laws, regulations, and ethical standards. Oversight is a critical governance function performed by senior management, boards of directors, committees, or other internal or external bodies.

Performance audit

An independent, objective, and systematic assessment of how well government is managing its activities, responsibilities, and resources in a given sector of activity.

Production Sharing Agreement (PSA)

A common type of contract signed between a government and a resource extraction company (or group of companies) concerning how much of the extracted resource's value each will receive. In a PSA, the government awards the execution of exploration and production activities to an oil and gas company. The company bears the mineral and financial risk of the initiative and explores, develops and ultimately operates the field as required. The company is permitted to use the money initially generated from oil and gas sales to recover capital and operational expenditures. The remaining money is known as "profit oil" and is split between the government and the company.

Remediation

The removal of pollution or contaminants from environmental media such as soil, groundwater, sediment, or surface water. Remediation may also involve the revegetation of a perturbed area with local species and returning an area's topography to its pre-disturbance state.

Revenue framework

The specific mix of revenue sources adopted by a government to meet its fiscal objectives in relation to the development of a natural resource. The mix may include royalties, leases, fees, bonuses, penalties, or other revenue sources.

Risk

An event or action that may adversely affect an organization's ability to achieve its objectives. Assessing risk involves considering the *probability* (or likelihood) of the event occurring and the potential *impact* of that event.

Royalties

The price that the owner of a natural resource (usually a government) charges a private company for the right to develop the resource. The Supreme Court of Canada has defined royalties as a property right, specifically a contractually stipulated share of production or the proceeds thereof.

Royalty return

The documentation, similar to an income tax return, that oil and gas companies must file with a revenue agency or natural resource department to establish the amount of royalties they owe for a determined period of time. This documentation may include information on production volumes, market prices, profits, deductions, and so forth.

Significance

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors. Such factors include the magnitude of the matter in relation to the subject matter of the audit, the nature and effect of the matter, the relevance of the matter, the needs and interests of third parties, and the impact of the matter to the audited program or activity.

Transfer mispricing

Transfer pricing is a business practice that consists of setting the price for the purchase of a good or service between two "related parties" (e.g. subsidiary companies that are owned or controlled by the same parent company). Transfer pricing becomes abusive when the related parties distort the price of a transaction to reduce their taxable income. This is known as transfer mispricing.

[Back to Table of Contents](#)