# VI. Appendices

# Appendix A - Financial section

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# Financial summary (U.S. GAAP)

| millions of dollars | **2012** | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Operating revenues | **31,053** | 30,474 | 24,946 | 21,292 | 31,240 |
| | | | | | |
| Net income by segment: | | | | | |
| Upstream | **1,888** | 2,457 | 1,764 | 1,324 | 2,923 |
| Downstream | **1,772** | 884 | 442 | 278 | 796 |
| Chemical | **165** | 122 | 69 | 46 | 100 |
| Corporate and other | **(59)** | (92) | (65) | (69) | 59 |
| Net income | **3,766** | 3,371 | 2,210 | 1,579 | 3,878 |
| | | | | | |
| Cash and cash equivalents at year end | **482** | 1,202 | 267 | 513 | 1,974 |
| Total assets at year end | **29,364** | 25,429 | 20,580 | 17,473 | 17,035 |
| | | | | | |
| Long-term debt at year end | **1,175** | 843 | 527 | 31 | 34 |
| Total debt at year end | **1,647** | 1,207 | 756 | 140 | 143 |
| Other long-term obligations at year end | **3,983** | 3,876 | 2,753 | 2,839 | 2,254 |
| | | | | | |
| Shareholders’ equity at year-end | **16,377** | 13,321 | 11,177 | 9,439 | 9,065 |
| Cash flow from operating activities | **4,680** | 4,489 | 3,207 | 1,591 | 4,263 |
| | | | | | |
| Per-share information (dollars) | | | | | |
| Net income per share - basic | **4.44** | 3.98 | 2.61 | 1.86 | 4.39 |
| Net income per share - diluted | **4.42** | 3.95 | 2.59 | 1.84 | 4.36 |
| Dividends | **0.48** | 0.44 | 0.43 | 0.40 | 0.38 |

# Frequently used terms

Listed below are definitions of several of Imperial's key business and financial performance measures. The definitions are provided to facilitate understanding of the terms and how they are calculated.

### Capital employed

Capital employed is a measure of net investment. When viewed from the perspective of how capital is used by the business, it includes the company's property, plant and equipment and other assets, less liabilities, excluding both short-term and long-term debt. When viewed from the perspective of the sources of capital employed in total for the company, it includes total debt and equity. Both of these views include the company's share of amounts applicable to equity companies, which the company believes should be included to provide a more comprehensive measurement of capital employed.

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Business uses: asset and liability perspective | | | |
| Total assets | **29,364** | 25,429 | 20,580 |
| Less: total current liabilities excluding notes and loans payable | **(5,433)** | (5,585) | (4,348) |
| total long-term liabilities excluding long-term debt | **(5,907)** | (5,316) | (4,299) |
| Add: Imperial's share of equity company debt | **24** | 28 | 33 |
| Total capital employed | **18,048** | 14,556 | 11,966 |
| | | | |
| Total company sources: debt and equity perspective | | | |
| Notes and loans payable | **472** | 364 | 229 |
| Long-term debt | **1,175** | 843 | 527 |
| Shareholders' equity | **16,377** | 13,321 | 11,177 |
| Add: Imperial's share of equity company debt | **24** | 28 | 33 |
| Total capital employed | **18,048** | 14,556 | 11,966 |

### Return on average capital employed (ROCE)

ROCE is a financial performance ratio. From the perspective of the business segments, ROCE is annual business-segment net income divided by average business-segment capital employed (an average of the beginning- and end-of-year amounts). Segment net income includes Imperial's share of segment net income of equity companies, consistent with the definition used for capital employed, and excludes the cost of financing. The company's total ROCE is net income excluding the after-tax cost of financing divided by total average capital employed. The company has consistently applied its ROCE definition for many years and views it as the best measure of historical capital productivity in a capital-intensive, long-term industry to both evaluate management's performance and demonstrate to shareholders that capital has been used wisely over the long term. Additional measures, which are more cash flow based, are used to make investment decisions.

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **3,766** | 3,371 | 2,210 |
| Financing costs (after tax), including Imperial's share of equity companies | **1** | 1 | 2 |
| Net income excluding financing costs | **3,767** | 3,372 | 2,212 |
| | | | |
| Average capital employed | **16,302** | 13,261 | 10,791 |
| Return on average capital employed (percent) – corporate total | **23.1** | 25.4 | 20.5 |

**Cash flow from operating activities and asset sales**

Cash flow from operating activities and asset sales is the sum of the net cash provided by operating activities and proceeds from asset sales reported in the consolidated statement of cash flows. This cash flow reflects the total sources of cash both from operating the company's assets and from the divesting of assets. The company employs a long-standing and regular disciplined review process to ensure that all assets are contributing to the company's strategic objectives. Assets are divested when they no longer meet these objectives or are worth considerably more to others. Because of the regular nature of this activity, the company believes it is useful for investors to consider sales proceeds together with cash provided by operating activities when evaluating cash available for investment in the business and financing activities, including shareholder distributions.

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Cash from operating activities | **4,680** | 4,489 | 3,207 |
| Proceeds from asset sales | **226** | 314 | 144 |
| Total cash flow from operating activities and asset sales | **4,906** | 4,803 | 3,351 |

**Operating costs**

Operating costs are the costs during the period to produce, manufacture, and otherwise prepare the company's products for sale – including energy costs, staffing and maintenance costs. They exclude the cost of raw materials, taxes and interest expense and are on a before-tax basis. While the company is responsible for all revenue and expense elements of net income, operating costs, as defined below, represent the expenses most directly under the company's control and therefore, are useful in evaluating the company's performance.

**Reconciliation of Operating Costs**

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| **From Imperial's Consolidated Statement of Income** | | | |
| Total expenses | **26,195** | 26,308 | 22,138 |
| Less: | | | |
| Purchases of crude oil and products | **18,476** | 18,847 | 14,811 |
| Federal excise tax | **1,338** | 1,320 | 1,316 |
| Financing costs | **(1)** | 3 | 7 |
| Subtotal | **19,813** | 20,170 | 16,134 |
| Imperial's share of equity company expenses | **34** | 39 | 39 |
| Total operating costs | **6,416** | 6,177 | 6,043 |

**Components of Operating Costs**

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| **From Imperial's Consolidated Statement of Income** | | | |
| Production and manufacturing | **4,457** | 4,114 | 3,996 |
| Selling and general | **1,081** | 1,168 | 1,070 |
| Depreciation and depletion | **761** | 764 | 747 |
| Exploration | **83** | 92 | 191 |
| Subtotal | **6,382** | 6,138 | 6,004 |
| Imperial's share of equity company expenses | **34** | 39 | 39 |
| Total operating costs | **6,416** | 6,177 | 6,043 |

# Management’s discussion and analysis of financial condition and results of operations

## Overview

The following discussion and analysis of Imperial’s financial results, as well as the accompanying financial statements and related notes to consolidated financial statements to which they refer, are the responsibility of the management of Imperial Oil Limited.

The company’s accounting and financial reporting fairly reflect its straightforward business model involving the extracting, refining and marketing of hydrocarbons and hydrocarbon-based products. The company’s business involves the production (or purchase), manufacture and sale of physical products, and all commercial activities are directly in support of the underlying physical movement of goods.

Imperial, with its resource base, financial strength, disciplined investment approach and technology portfolio, is well-positioned to participate in substantial investments to develop new Canadian energy supplies. While commodity prices remain volatile on a short-term basis depending upon supply and demand, Imperial’s investment decisions are based on its long-term business outlook, using a disciplined approach in selecting and pursuing the most attractive investment opportunities. The corporate plan is a fundamental annual management process that is the basis for setting near-term operating and capital objectives, in addition to providing the longer-term economic assumptions used for investment evaluation purposes. Potential investment opportunities are tested over a wide range of economic scenarios to establish the resiliency of each opportunity. Once investments are made, a reappraisal process is completed to ensure relevant lessons are learned and improvements are incorporated into future projects.

The term “project” as used in this report does not necessarily have the same meaning as under SEC Rule 13q-1 relating to government payment reporting. For example, a single project for purposes of the rule may encompass numerous properties, agreements, investments, developments, phases, work efforts, activities and components, each of which we may also informally describe as a “project”.

## Business environment and risk assessment

**Long-term business outlook**
By 2040, the world's population is projected to grow to approximately 8.7 billion people, or about 1.9 billion more than in 2010. Coincident with this population increase, the company expects worldwide economic growth to average close to 3 percent per year. Expanding prosperity across a growing global population is expected to coincide with an increase in primary energy demand of about 35 percent by 2040 versus 2010, even with substantial efficiency gains around the world. This demand increase is expected to be concentrated in emerging and developing countries (i.e., those that are not member nations of the Organization for Economic Cooperation and Development).

As economic progress for billions of people drives demand higher, increasing penetration of energy-efficient and lower-emission fuels, technologies and practices are expected to contribute to significantly lower levels of energy consumption and emissions per unit of economic output over time. Efficiency gains will result from anticipated improvements in the transportation and power generation sectors, driven by the penetration of advanced technologies, as well as many other improvements that span the residential, commercial and industrial sectors.

Energy for transportation - including cars, trucks, ships, trains and airplanes - is expected to increase by about 40 percent from 2010 to 2040. The global growth in transportation demand is likely to account for approximately 70 percent of the growth in liquid fuels demand over this period. Nearly all the world's transportation fleets will continue to run on liquid fuels because they provide a large quantity of energy in small volumes, making them easy to transport and widely available.

Demand for electricity around the world is estimated to increase approximately 85 percent by 2040, led by growth in developing countries. Consistent with this projection, power generation is expected to remain the largest and fastest-growing major segment of global energy demand. Meeting the expected growth in power demand will require a diverse set of energy sources. Natural gas demand is likely to grow most significantly and become the leading source of generated electricity by 2040, reflecting the efficiency of gas-fired power plants.

Today, coal has the largest fuel share in the power sector, but its share is likely to decline significantly by 2040 as policies are gradually adopted to reduce environmental impacts including those related to local air quality and greenhouse gas emissions. Nuclear power and renewables, led by wind, are expected to grow significantly over the period.

Liquid fuels provide the largest share of energy supply today due to their broad-based availability, affordability and ease of transport to meet consumer needs. By 2040, global demand for liquids is expected to grow to approximately 113 million barrels of oil-equivalent a day, an increase of about 30 percent from 2010. Global demand for liquid fuels will be met by a wide variety of sources. Conventional crude and condensate production is expected to remain relatively flat through 2040. However, growth is expected from a wide variety of sources, including deep-water resources, oil sands, tight oil, natural gas liquids, and biofuels. The world's resource base is sufficient to meet projected demand through 2040 as technology advances continue to expand the availability of economic supply options. However, access to resources and timely investments will remain critical to meeting global needs with reliable, affordable supplies.

Natural gas is a versatile fuel for a wide variety of applications, and is expected to be the fastest growing major fuel source through 2040. Global demand is expected to rise about 65 percent from 2010 to 2040, with demand increases in major regions around the world requiring new sources of supply. Helping meet these needs will be significant growth in supplies of unconventional gas - the natural gas found in shale and other rock formations that was once considered uneconomic to produce. By 2040, unconventional gas is likely to approach one-third of global gas supplies, up from less than 15 percent in 2010. Growing natural gas demand will also stimulate significant growth in the worldwide liquefied natural gas (LNG) market, which is expected to reach about 15 percent of global gas demand by 2040.

The world's energy mix is highly diverse and will remain so through 2040. Oil is expected to remain the largest source of energy with its share remaining close to one-third in 2040. Coal is currently the second largest source of energy, but it is likely to lose that position to natural gas by approximately 2025. The share of natural gas is expected to exceed 25 percent by 2040, while the share of coal falls to less than 20 percent. Nuclear power is projected to grow significantly, albeit at a slower pace than otherwise expected in the aftermath of the Fukushima incident in Japan following the earthquake and tsunami in March 2011. Total renewable energy is likely to reach close to 15 percent of total energy by 2040, including biomass, hydro and geothermal at a combined share of about 11 percent. Total energy supplied from wind, solar and biofuels is expected to increase close to 450 percent from 2010 to 2040, reaching a combined share of 3 to 4 percent of world energy.

The company anticipates that the world's available oil and gas resource base will grow not only from new discoveries, but also from reserve increases in previously discovered fields. Technology will underpin these increases. The cost to develop and supply these resources will be significant. According to the International Energy Agency, the investment required to meet total oil and gas energy needs worldwide over the period 2012- 2035 will be close to $19 trillion (measured in 2011 dollars), or close to $800 billion per year on average.

International accords and underlying regional and national regulations for greenhouse gas reduction are evolving with uncertain timing and outcome, making it difficult to predict their business impact. Imperial's estimates of potential costs related to possible public policies covering energy-related greenhouse gas emissions are consistent with those outlined in ExxonMobil's long-term Energy Outlook, which is used for assessing the business environment and Imperial's investment evaluations.

The information provided in the Long-term Business Outlook includes internal estimates and forecasts based upon internal data and analyses as well as publicly available information from external sources including the International Energy Agency.

**Upstream**

Imperial produces crude oil and natural gas for sale into the North American markets. Crude oil and natural gas prices are determined by global and North American markets and are subject to changing supply and demand conditions. These can be influenced by a wide range of factors, including economic conditions, international political developments and weather. Prices for most of the company's crude oil sold are set on West Texas Intermediate (WTI) oil markets, a common benchmark for mid-continent North American markets. In 2012, the average price of WTI crude oil and the company's Western Canadian liquids realizations continued to be markedly lower than that of Brent crude oil, a common benchmark for Atlantic Basin oil markets, due to supply/demand imbalances in mid-continent North American markets.

Imperial's Upstream business strategies guide the company's exploration, development, production, research and gas marketing activities. These strategies include identifying and selectively capturing the highest quality opportunities, and maximizing the profitability of existing production and resource value through high-impact technologies. These strategies are underpinned by a relentless focus on operational excellence, commitment to innovative technologies, development of employees and investment in the communities in which the company operates.

Imperial's proven development approach supported the company's continued investment in several key growth projects during a weak and uncertain economic environment following the global financial crisis in 2008. The company continues a decade-long growth strategy in which about $40 billion will be invested to meet its plan of doubling upstream production by the end of this decade. Actual spending and production volumes could vary depending on the progress of individual projects. To support the company's long-term growth in oil sands production, a variety of existing and new logistics outlets have been secured or are being developed.

Imperial has a large portfolio of oil and gas resources in Canada, both developed and undeveloped, which helps reduce the risks of dependence on potentially limited supply sources in the Upstream. With the relative maturity of conventional production in established producing areas, Imperial's production is expected to come increasingly from unconventional and frontier sources, particularly oil sands, unconventional natural gas and from Canada's North, where Imperial has large undeveloped resource opportunities.

**Subsequent event**

On February 26, 2013, ExxonMobil Canada acquired 100 percent of Celtic Exploration Ltd. ("Celtic"). Immediately following the acquisition, Imperial acquired a 50-percent interest in Celtic's assets and liabilities from ExxonMobil Canada for $1.6 billion, financed by a combination of related party and third party debt.

Imperial acquired a 50-percent participating interest in 545,000 net acres in the liquids-rich Montney shale, 104,000 net acres in the Duvernay shale and additional acreage in other areas of Alberta, Canada. Current net production of the acreage is about 70 million cubic feet a day of natural gas and about 3,900 barrels a day of crude oil, condensate and natural gas liquids. The resources contained in these acreages, together with Imperial's and ExxonMobil's technical expertise and financial strength, should enable development of additional supplies of unconventional natural gas and liquid resources.

The acquisition should be accretive to Imperial's production growth and cash flow. However, it is not likely to have a material impact to Imperial's near-term earnings per share.

Reference is made to Financial Statement note 17: Subsequent event for further details.

**Downstream**

The downstream industry environment is expected to continue being very competitive in the mature North America market. Crude oil, the primary raw material in a refinery operation, and its many refined products are widely traded with published international prices. Prices for these commodities are determined by the marketplace and are affected by many factors, including global and regional supply/demand balances, inventory levels, refinery operations, import/export balances, transportation logistics, currency fluctuations, seasonality and weather. The average prices the company paid for most of its crude oil processed at three of the company's four refineries are set on Western Canadian crude oil markets. In 2012, the average prices of Western Canadian crude oils continued to be markedly lower than that of Brent crude oil. Canadian wholesale prices of refined products in particular are largely determined by wholesale prices in adjacent U.S. regions, where wholesale prices are predominantly tied to international product markets. Stronger industry refining margins in 2012 were the result of the widened differential between product prices and cost of crude oil processed. These prices and factors are continually monitored and provide input to operating decisions about which raw materials to buy, facilities to operate and products to make. However, there are no reliable indicators of future market factors that accurately predict changes in margins from period to period.

The company will continue to focus on the business elements within its control. Imperial's Downstream strategies are to provide customers with quality, valued products and services at the lowest total cost offer, have the lowest unit costs among industry competitors, ensure efficient and effective use of capital, maximize value from leading edge technologies and capitalize on the integration with the company's other businesses.

Imperial owns and operates four refineries in Canada, with aggregate distillation capacity of 506,000 barrels a day. Imperial's fuels marketing business includes retail operations across Canada serving customers through more than 1,770 Esso-branded retail service stations, of which about 470 are company-owned or leased, as well as wholesale and industrial operations through a network of 22 primary distribution terminals, as well as a secondary distribution network.

In the second quarter of 2012, Imperial announced its intention to market the Dartmouth refinery and related supply terminals to prospective buyers. At year-end 2012, the Dartmouth refinery had a rated capacity of 85 thousand barrels a day. The company is also assessing alternatives including conversion to a products terminal. A decision is expected in 2013.

**Chemical**

The North American petrochemical industry continued to improve in 2012 reflecting improving North American economic conditions. In North America, unconventional natural gas continued to provide advantaged ethane feedstock for steam crackers and a favourable margin environment for integrated chemical producers. Progress continued on the infrastructure required to implement a long-term supply agreement for ethane from the nearby Marcellus shale gas development. First deliveries of this cost-advantage feedstock to the company's Sarnia chemical plant are expected around mid-2013. The company's strategy for its Chemical business is to reduce costs and maximize value by continuing to increase the integration of its chemical plants at Sarnia and Dartmouth with the refineries. The company also benefits from its integration within ExxonMobil's North American chemical businesses, enabling Imperial to maintain a leadership position in its key market segments.

## Management’s discussion and analysis of financial condition and results of operations (continued)

## Results of operations

### Consolidated

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **3,766** | 3,371 | 2,210 |

2012
Net income in 2012 was $3,766 million or $4.42 a share on a diluted basis, versus $3,371 million or $3.95 a share in 2011. Increased earnings were primarily attributable to stronger industry refining margins of about $975 million and lower royalty costs of about $300 million due to lower Upstream realizations. These factors were partially offset by the impacts of lower Upstream realizations of about $580 million, higher Kearl production readiness costs of about $125 million and higher refinery planned maintenance of about $80 million. Gains on asset divestments were also lower by about $85 million in 2012.

In 2012, the average price of West Texas Intermediate (WTI) crude oil and Western Canadian crude oils continued to be markedly lower than that of Brent crude oil, a common benchmark for Atlantic Basin oil markets, due to supply/demand imbalances in mid-continent North American markets. This price discount negatively impacted the company’s Western Canadian liquids realizations. Refining margins in the company’s Downstream segment, however, benefited as the overall cost of crude oil processed at three of the company’s four refineries followed the trend of Western Canadian crude oils.

2011
Net income in 2011 was $3,371 million or $3.95 a share on a diluted basis, versus $2,210 million or $2.59 a share in 2010. Increased earnings were primarily attributable to higher crude oil commodity prices, stronger industry refining margins and increased Cold Lake bitumen production. These factors were partially offset by the unfavourable impacts of higher royalty costs, the stronger Canadian dollar and lower conventional crude oil volumes due to third-party pipeline reliability issues. 2011 earnings also included higher gains of about $70 million on asset divestments.

In 2011, there was an unusually large spread between the prices of Brent crude oil and WTI crude oil, two common benchmarks for world oil markets. Increase in 2011 in the average Brent crude oil price more than doubled that of the average WTI price due to continued weakness in WTI crude oil markets. Increases in the company’s Upstream realizations in 2011 followed more closely the trend of WTI prices, while margins in the company’s Downstream segment benefited as the overall cost of crude oil processed at three of the company’s four refineries were more in line with WTI prices.

### Upstream

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **1,888** | 2,457 | 1,764 |

2012
Net income for the year was $1,888 million, down $569 million from 2011. Earnings were lower primarily due to the impacts of lower realizations of about $580 million, higher Kearl production readiness costs of about $125 million and lower Cold Lake volumes of about $75 million. Gains on asset divestments were also lower by about $85 million in 2012. These factors were partially offset by lower royalty costs of about $300 million due to lower realizations and higher conventional volumes of about $45 million.

2011
Net income for the year was $2,457 million, up $693 million from 2010. Earnings increased primarily due to the impacts of higher crude oil commodity prices of about $925 million and increased Cold Lake bitumen production of about $260 million. These factors were partially offset by the unfavourable effects of higher royalty costs due to higher crude oil commodity prices of about $245 million, the stronger Canadian dollar of about $150 million, and lower conventional crude oil volumes of about $150 million, of which about $80 million was a result of third-

party pipeline reliability issues. Included in 2011 earnings were gains of $116 million on asset divestments, about $95 million higher than 2010.

**Average realizations**

| Canadian dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Conventional crude oil realizations (a barrel) | **77.19** | 85.22 | 71.64 |
| Natural gas liquids realizations (a barrel) | **42.06** | 59.08 | 50.09 |
| Natural gas realizations (a thousand cubic feet) | **2.33** | 3.59 | 4.04 |
| Synthetic oil realizations (a barrel) | **92.48** | 101.43 | 80.63 |
| Bitumen realizations (a barrel) | **59.76** | 63.95 | 58.36 |

2012

Prices for most of the company's liquids production are based on WTI crude oil, a common benchmark for mid-continent North American oil markets. Compared to 2011, the average WTI crude price in U.S. dollars was lower by $0.96 a barrel or about one percent in 2012. The company's Western Canadian liquids realizations were also impacted by market discounts caused by supply/demand imbalances in mid-continent North America. In 2012, the company's conventional and synthetic crude oil realizations in Canadian dollars decreased by about nine percent and bitumen realizations in Canadian dollars decreased by about seven percent compared to 2011.

The company's average realizations on natural gas sales were lower by about 35 percent in 2012 in line with the decline in the average of 30-day spot prices for natural gas in Alberta.

2011

The average price of Brent crude oil in U.S. dollars, a common benchmark for Atlantic Basin oil markets, was $111.29 a barrel in 2011, up about 40 percent from the previous year. Increase in the average price of West Texas Intermediate (WTI) crude oil, a common benchmark for mid-continent North American oil markets, was limited to 19 percent, due to the continued weakness in WTI crude oil markets. Increases in the company's average realizations on sales of Canadian conventional crude oil and synthetic crude oil were in line with that of WTI.

The company's average bitumen realizations in Canadian dollars in 2011 increased ten percent to $63.95 per barrel as the price spread between light crude oil and Cold Lake bitumen widened.

Canadian natural gas prices in 2011 were lower than the previous year. The average of 30-day spot prices for natural gas in Alberta at $3.67 a thousand cubic feet were down from $4.39 in 2010. The company's realizations for natural gas averaged $3.59 a thousand cubic feet, down from $4.04 in 2010.

**Crude oil and NGLs - production and sales** (a)

| thousands of barrels a day | **2012** | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|
| | **gross** | **net** | gross | net | gross | net |
| Bitumen | **154** | **123** | 160 | 120 | 144 | 115 |
| Synthetic oil | **72** | **69** | 72 | 67 | 73 | 67 |
| Conventional crude oil | **20** | **15** | 18 | 13 | 23 | 17 |
| Total crude oil production | **246** | **207** | 250 | 200 | 240 | 199 |
| NGLs available for sale | **4** | **3** | 5 | 4 | 7 | 5 |
| Total crude oil and NGL production | **250** | **210** | 255 | 204 | 247 | 204 |
| Cold Lake sales, including diluent (b) | **201** | | 209 | | 188 | |
| NGL sales | **8** | | 9 | | 10 | |

**Natural gas - production and sales** (a)

| millions of cubic feet a day | **2012** | | 2011 | | 2010 | |
|---|---|---|---|---|---|---|
| | **gross** | **net** | gross | net | gross | net |
| Production (c) | **192** | **195 (d)** | 254 | 228 | 280 | 254 |
| Sales | **177** | | 237 | | 264 | |

(a) Daily volumes are calculated by dividing total volumes for the year by the number of days in the year. Gross production is the company's share of production (excluding purchases) before deducting the share of mineral owners or governments or both. Net production excludes those shares.
(b) Diluent is natural gas condensate or other light hydrocarbons added to Cold Lake bitumen to facilitate transportation to market by pipeline.
(c) Production of natural gas includes amounts used for internal consumption with the exception of the amounts re-injected.
(d) Net production included favourable royalty cost adjustments.

2012
Gross production of Cold Lake bitumen averaged 154,000 barrels a day in 2012 compared with 160,000 barrels in 2011. Lower volumes were primarily due to the cyclic nature of production at Cold Lake.

The company's share of Syncrude's gross production averaged 72,000 barrels a day, unchanged from 2011.

Gross production of conventional crude oil averaged 20,000 barrels a day, up from the 18,000 barrels in 2011 when third-party pipeline downtime reduced production at the Norman Wells field.

Gross production of natural gas in 2012 was 192 million cubic feet a day, down from 254 million cubic feet in 2011. The lower production volume was primarily a result of producing properties divestments completed in 2011.

2011
Gross production of Cold Lake bitumen increased to a record 160,000 barrels a day in 2011 from 144,000 barrels in 2010. Increased volumes were due to contributions from new wells steamed in 2010 and 2011, increased recoveries as a result of technology applications and the cyclic nature of production at Cold Lake.

The company's share of gross production from Syncrude averaged 72,000 barrels a day, in line with 73,000 barrels in 2010.

Gross production of conventional crude oil averaged 18,000 barrels a day, compared with 23,000 barrels in 2010. Lower volumes were primarily due to third-party pipeline unplanned downtime, which reduced production at the Norman Wells field, along with natural reservoir decline.

Gross production of natural gas in 2011 was 254 million cubic feet a day, down from 280 million cubic feet in 2010. The lower production volume was primarily a result of natural reservoir decline.

In 2011, the company sold its interests in shallow gas properties in the Medicine Hat, Alberta area, the Coleville-Hoosier natural gas producing property in Saskatchewan and the Rainbow Lake producing property in Alberta, realizing a gain of about $76 million. Production for the company's share of the properties averaged about 56 million cubic feet of natural gas a day and one thousand barrels of crude oil a day in 2010. Also in the year, the company recorded a gain of about $40 million from an exchange of oil sands leases with a third party.

### Downstream

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **1,772** | 884 | 442 |

2012
Downstream net income was $1,772 million, an increase of $888 million over 2011. Earnings in 2012 were the best annual earnings on record and were primarily due to stronger industry refining margins, partially offset by increased operating expenditures due to the impact of a higher level of refinery planned maintenance activities compared with 2011.

The overall cost of crude oil processed at three of the company’s four refineries followed the trend of Western Canadian crude oils. Canadian wholesale prices of refined products are largely determined by wholesale prices in adjacent U.S. regions, where wholesale prices are predominately tied to international product markets. Stronger industry refining margins are the result of the widened differential between product prices and cost of crude oil processed.

2011
Net income was $884 million, an increase of $442 million over 2010. Higher earnings were primarily due to the favourable impact of stronger industry refining margins of about $590 million. Refining margins benefited as the overall cost of crude oil processed at three of the company’s four refineries followed the trend of WTI prices. This factor was partially offset by the unfavourable impacts of higher maintenance activities on refinery operations and expenses totaling about $60 million and the stronger Canadian dollar of about $55 million. Earnings in 2010 included a gain of about $25 million from sale of non-operating assets.

**Refinery utilization**

| thousands of barrels a day (a) | **2012** | 2011 | 2010 |
|---|---|---|---|
| Total refinery throughput (b) | **435** | 430 | 444 |
| Refinery capacity at December 31 | **506** | 506 | 502 |
| Utilization of total refinery capacity (percent) | **86** | 85 | 88 |

**Sales**

| thousands of barrels a day (a) | **2012** | 2011 | 2010 |
|---|---|---|---|
| Gasolines | **221** | 220 | 218 |
| Heating, diesel and jet fuels | **151** | 157 | 153 |
| Heavy fuel oils | **30** | 29 | 28 |
| Lube oils and other products | **43** | 41 | 43 |
| Net petroleum product sales | **445** | 447 | 442 |

(a) Volumes a day are calculated by dividing total volumes for the year by the number of days in the year.
(b) Crude oil and feedstocks sent directly to atmospheric distillation units.

2012
Total refinery throughput was 435,000 barrels a day, up from 2011, and average refinery capacity utilization increased to 86 percent from the previous year's 85 percent. Higher volumes and utilization were primarily a result of improved refinery operations partially offset by higher planned maintenance activities at the Strathcona refinery. Total net petroleum sales decreased to 445,000 barrels a day, 2,000 barrels lower than 2011.

2011
Total refinery throughput was 430,000 barrels a day, down from 2010, and average refinery capacity utilization decreased to 85 percent from the previous year's 88 percent. Lower volumes and utilization were primarily a result of higher planned and unplanned maintenance activities. Total net petroleum sales increased to 447,000 barrels a day, 5,000 barrels higher than 2010.

## **Management's discussion and analysis of financial condition and results of operations** (continued)

### Chemical

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **165** | 122 | 69 |

#### Sales

| thousands of tonnes | **2012** | 2011 | 2010 |
|---|---|---|---|
| Polymers and basic chemicals | **767** | 748 | 711 |
| Intermediate and others | **277** | 268 | 278 |
| Total petrochemical sales | **1,044** | 1,016 | 989 |

2012
Net income was $165 million, up $43 million from 2011. Earnings in 2012 were the best annual earnings on record. Strong operating performance along with higher polyethylene margins and sales volumes were the main contributors to the increase.

2011
Net income was $122 million, up $53 million from 2010. Improved margins for intermediate and aromatic products, lower costs due to lower planned maintenance activities and higher polyethylene sales volumes were the main contributors to the increase. These factors were partially offset by lower margins for polyethylene products.

### Corporate & Other

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Net income | **(59)** | (92) | (65) |

2012
Net income effects from Corporate & Other were negative $59 million, compared with negative $92 million in 2011. Favourable effects were due to lower share-based compensation charges.

2011
Net income effects were negative $92 million, versus negative $65 million reported last year. Unfavourable effects in 2011 were primarily due the impact of the share price change on share-based compensation charges.

## Management's discussion and analysis of financial condition and results of operations (continued)

## Liquidity and capital resources

### Sources and uses of cash

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Cash provided by/(used in) | | | |
| Operating activities | **4,680** | 4,489 | 3,207 |
| Investing activities | **(5,238)** | (3,593) | (3,709) |
| Financing activities | **(162)** | 39 | 256 |
| Increase/(decrease) in cash and cash equivalents | **(720)** | 935 | (246) |
| Cash and cash equivalents at end of year | **482** | 1,202 | 267 |

Although the company issues long-term debt from time to time and maintains a commercial paper program, internally generated funds cover the majority of its financial requirements. Cash that may be temporarily available as surplus to the company's immediate needs is carefully managed through counterparty quality and investment guidelines to ensure that it is secure and readily available to meet the company's cash requirements and to optimize returns.

Cash flows from operating activities are highly dependent on crude oil and natural gas prices, as well as petroleum and chemical product margins. In addition, to provide for cash flow in future periods, the company needs to continually find and develop new resources, and continue to develop and apply new technologies to existing fields in order to maintain or increase production. Projects are planned or underway to increase production capacity. However, these volume increases are subject to a variety of risks, including project execution, operational outages, reservoir performance and regulatory changes.

The company's financial strength enables it to make large, long-term capital expenditures. Imperial's portfolio of development opportunities and the complementary nature of its business segments help mitigate the overall risks for the company and its cash flows. Further, due to its financial strength, debt capacity and portfolio of opportunities, the risk associated with delay of any single project would not have a significant impact on the company's liquidity or ability to generate sufficient cash flows for its operations and fixed commitments.

An independent actuarial valuation of the company's registered retirement benefit plans was completed as at December 31, 2011. As a result of the valuation, the company contributed $594 million to the registered retirement benefit plans in 2012. The next required independent actuarial valuation will be as at December 31, 2012 and the company will continue to contribute within the requirements of pension regulations. Future funding requirements are not expected to affect the company's existing capital investment plans or its ability to pursue new investment opportunities.

### Cash flow from operating activities

2012
Cash flow generated from operating activities was $4,680 million, compared with $4,489 million in 2011. Higher cash flow was primarily due to deferred income tax effects and higher net income partially offset by working capital effects.

2011
Cash flow generated from operating activities was $4,489 million, an increase of $1,282 million from 2010 and in line with the earnings increase versus 2010.

### Cash flow from investing activities

2012
Investing activities used net cash of $5,238 million in 2012, compared to $3,593 million in 2011. Additions to property, plant and equipment were $5,478 million, compared with $3,919 million last year. Proceeds from asset sales were $226 million compared with $314 million in 2011.

2011
Investing activities used net cash of $3,593 million in 2011, compared to $3,709 million in 2010. Additions to property, plant and equipment were $3,919 million, compared with $3,856 million last year. Proceeds from asset sales were $314 million compared with $144 million in 2010.

### Cash flow from financing activities

2012
Cash used in financing activities was $162 million, compared with cash provided by financing activities of $39 million in 2011.

The company raised new debt of $325 million by drawing on existing facilities. Obligations under capital leases, which is a non-cash item, also increased by $115 million. At the end of 2012, total debt outstanding was $1,647 million, compared with $1,207 million at the end of 2011.

During 2012, the company did not make any share repurchases except those to offset the dilutive effects from the exercise of share-based awards. The company will continue to evaluate its share repurchase program in the context of its operating performance and overall capital project activities.

Cash dividends of $398 million were paid in 2012 compared with $373 million in 2011. Per-share dividends paid in 2012 totaled $0.48, up from $0.44 in 2011.

In the third quarter of 2012, the company increased the amount of its existing stand-by long-term bank credit facility from $200 million to $300 million and extended the maturity date to August 2014. Subsequent to year-end, in February 2013, this long-term bank credit facility was increased by an additional $200 million to $500 million with the maturity date unchanged. The company has not drawn on the facility.

In February 2013, the company increased its long-term debt by $1.3 billion by drawing on an existing facility with an affiliated company of Exxon Mobil Corporation and increased short-term debt by $0.5 billion by issuing additional commercial paper. The majority of the increased debt was used to finance the acquisition of a 50-percent interest in Celtic's assets and liabilities.

2011
Cash from financing activities was $39 million, compared with $256 million in 2010.

The company raised new debt of $455 million by drawing on existing facilities. At the end of 2011, total debt outstanding was $1,207 million, compared with $756 million at the end of 2010.

During 2011, the company did not make any share repurchases except those to offset the dilutive effects from the exercise of share-based awards. The company will continue to evaluate its share repurchase program in the context of its operating performance and overall capital project activities.

Cash dividends of $373 million were paid in 2011 compared with $356 million in 2010. Per-share dividends paid in 2011 totaled $0.44, up from $0.42 in 2010.

In the second quarter, the company extended the maturity date of its existing stand-by $200 million long term bank credit facility to July 2013. The company has not drawn on this facility.

### Financial percentages and ratios

| | **2012** | 2011 | 2010 |
|---|---|---|---|
| Total debt as a percentage of capital (a) | **9** | 9 | 7 |
| Interest coverage ratio – earnings basis (b) | **239** | 260 | 370 |

(a) Current and long-term debt (page A27) and the company's share of equity company debt, divided by debt and shareholders' equity (page A27).

(b) Net income (page A25), debt-related interest before capitalization, including the company's share of equity company interest, and income taxes (page A25), divided by debt-related interest before capitalization, including the company's share of equity company interest.

## Management's discussion and analysis of financial condition and results of operations (continued)

Debt represented nine percent of the company's capital structure at the end of 2012, unchanged from 2011.

Debt-related interest incurred in 2012, before capitalization of interest, was $20 million, compared with $16 million in 2011. The average effective interest rate on the company's debt was 1.6 percent in 2012, compared with 1.5 percent in 2011.

The company's financial strength, as evidenced by the above financial ratios, represents a competitive advantage of strategic importance. The company's sound financial position gives it the opportunity to access capital markets in the full range of market conditions and enables the company to take on large, long-term capital commitments in the pursuit of maximizing shareholder value.

The company does not use any derivative instruments to offset exposures associated with hydrocarbon prices, currency exchange rates and interest rates that arise from existing assets, liabilities and transactions. The company does not engage in speculative derivative activities nor does it use derivatives with leveraged features.

**Commitments**

The following table shows the company's commitments outstanding at December 31, 2012. It combines data from the consolidated balance sheet and from individual notes to the consolidated financial statements, where appropriate.

| millions of dollars | Financial statement note reference | Payment due by period 2013 | 2014 to 2017 | 2018 and beyond | Total amount |
|---|---|---|---|---|---|
| Long-term debt (a) | Note 14 | - | 1,066 | 109 | 1,175 |
| - Due in one year | | 7 | - | - | 7 |
| Operating leases (b) | Note 13 | 180 | 306 | 25 | 511 |
| Unconditional purchase obligations (c) | Note 9 | 77 | 217 | 176 | 470 |
| Firm capital commitments (d) | | 3,554 | 1,573 | 99 | 5,226 |
| Pension and other post-retirement obligations (e) | Note 4 | 733 | 227 | 1,809 | 2,769 |
| Asset retirement obligations (f) | Note 5 | 105 | 378 | 483 | 966 |
| Other long-term purchase agreements (g) | | 346 | 1,894 | 4,747 | 6,987 |

(a) Long-term debt includes a long-term loan from an affiliated company of Exxon Mobil Corporation of $1,040 million and capital lease obligations of $142 million, $7 million of which is due in one year. The payment by period for the related party long-term loan is estimated based on the right of the related party to cancel the loan on at least 370 days advance written notice.

(b) Minimum commitments for operating leases, shown on an undiscounted basis, primarily cover office buildings, rail cars and service stations.

(c) Unconditional purchase obligations are those long-term commitments that are non-cancelable or cancellable only under certain conditions and that third parties have used to secure financing for the facilities that will provide the contracted goods and services. They mainly pertain to pipeline throughput agreements.

(d) Firm capital commitments related to capital projects, shown on an undiscounted basis. The largest commitments outstanding at year-end 2012 were $3,293 million associated with the company's share of the Kearl project and $840 million associated with the Cold Lake Nabiye expansion project.

(e) The amount by which the benefit obligations exceeded the fair value of fund assets for pension and other post-retirement plans at year-end. The payments by period include expected contributions to funded pension plans in 2013 and estimated benefit payments for unfunded plans in all years.

(f) Asset retirement obligations represent the fair value of legal obligations associated with site restoration on the retirement of assets with determinable useful lives.

(g) Other long-term purchase agreements are non-cancelable, long-term commitments other than unconditional purchase obligations. They include primarily raw material supply and transportation services agreements.

In 2012, the company entered into additional long-term pipeline transportation agreements, which have a total commitment of about $4.4 billion, to ship heavy crude oil blend and diluent. These agreements will support the company's long-term growth in oil sands production. The company expects to fulfill these commitments in the normal course of business. The new commitment amounts are included in the "Other long–term purchase agreements" line in the table above.

Unrecognized tax benefits totaling $143 million have not been included in the company's commitments table because the company does not expect there will be any cash impact from the final settlements as sufficient funds have been deposited with the Canada Revenue Agency. Further details on the unrecognized tax benefits can be found in note 3 to the financial statements on page A35.

**Litigation and other contingencies**
As discussed in note 9 to the consolidated financial statements on page A44, a variety of claims have been made against Imperial Oil Limited and its subsidiaries. Based on a consideration of all relevant facts and circumstances, the company does not believe the ultimate outcome of any currently pending lawsuits against the company will have a material adverse effect on the company's operations, financial condition, or financial statements taken as a whole. There are no events or uncertainties beyond those already included in reported financial information that would indicate a material change in future operating results or financial condition.

## Capital and exploration expenditures

| millions of dollars | **2012** | 2011 |
|---|---|---|
| Upstream (a) | **5,518** | 3,880 |
| Downstream | **140** | 166 |
| Chemical | **4** | 4 |
| Other | **21** | 16 |
| Total | **5,683** | 4,066 |

(a) Exploration expenses included.

Total capital and exploration expenditures were $5,683 million in 2012, an increase of $1,617 million from 2011.

For the Upstream segment, capital expenditures were $5,518 million, compared with $3,880 million in 2011. Expenditures were primarily directed towards the advancement of Kearl initial development and expansion. Other investments included advancing the Nabiye expansion project at Cold Lake and sustaining capital for Syncrude mining and tailing projects.

By 2012 year end, the construction of the Kearl initial development was complete and phased start-up activities were underway. Despite U.S. permitting and regulatory issues that continued for almost two years involving transportation of facility modules and significant challenges including an early onset of winter and exceptionally harsh weather during current start-up operations, production of mined diluted bitumen from the first froth treatment train is expected to be in the first quarter of 2013. The final cost for the initial development is expected to be $12.9 billion, of which the company's share is $9.2 billion.

Planned capital and exploration expenditures in the Upstream segment are forecast at about $6.8 billion for 2013. Investments are mainly planned for the continued investment in the Kearl and Nabiye growth projects, along with sustaining capital for Syncrude mining and tailing projects. The planned capital and exploration expenditures also include $1.6 billion associated with Imperial's 50 percent participation in the acquisition of Celtic.

For the Downstream segment, capital expenditures were $140 million in 2012, compared with $166 million in 2011. In 2012, Downstream capital expenditures focused mainly on refinery projects to improve reliability, feedstock flexibility, energy efficiency and environmental performance.

Planned capital expenditures for the Downstream segment in 2013 are about $200 million, focused on improving refinery reliability and environmental and safety performance, as well as continuing upgrades to the retail network.

The company continues a decade-long growth strategy in which about $40 billion will be invested. Total capital and exploration expenditures for the company in 2013 are expected to be about $7 billion. Actual spending could vary depending on the progress of individual projects.

## Market risks and other uncertainties

Crude oil, natural gas, petroleum product and chemical prices have fluctuated in response to changing market forces. The impacts of these price fluctuations on earnings from Upstream, Downstream and Chemical operations have varied. In addition, industry crude oil and natural gas commodity prices and petroleum and chemical product prices are commonly benchmarked in U.S. dollars. The majority of Imperial's sales and purchases are related to these industry U.S. dollar benchmarks. As the company records and reports its financial results in Canadian dollars, to the extent that the Canadian/U.S. dollar exchange rate fluctuates, the company's earnings will be affected. The company's potential exposure to commodity price and margin and Canadian/U.S. dollar exchange rate fluctuations is summarized in the earnings sensitivities table below, which shows the estimated annual effect, under current conditions, of the company's after-tax net income.

**Earnings sensitivities** (a)

| millions of dollars, after tax | | |
|---|---|---|
| Seven dollars (U.S.) a barrel change in crude oil prices | + (-) | 340 |
| Thirty cents a thousand cubic feet change in natural gas prices | + (-) | 5 |
| Two dollars (U.S.) a barrel change in sales margins for total petroleum products | + (-) | 250 |
| One cent (U.S.) a pound change in sales margins for polyethylene | + (-) | 6 |
| One-quarter percent decrease (increase) in short-term interest rates | + (-) | 3 |
| Ten cents decrease (increase) in the value of the Canadian dollar versus the U.S. dollar | + (-) | 490 |

(a) The amount quoted to illustrate the impact of each sensitivity represents a change of about 10 percent in the value of the commodity or rate in question at the end of 2012. Each sensitivity calculation shows the impact on net income resulting from a change in one factor, after tax and royalties and holding all other factors constant. While these sensitivities are applicable under current conditions, they may not apply proportionately to larger fluctuations.

The sensitivity of net income to changes in crude oil prices increased from year-end 2011 by about $16 million (after tax) a year for each one U.S. dollar change. The increase was primarily a result of the impact of lower royalty costs for bitumen production due to lower prices for Cold Lake bitumen at 2012 year-end.

The global energy markets can give rise to extended periods in which market conditions are adverse to one or more of the company's businesses. Such conditions, along with the capital-intensive nature of the industry and very long lead times associated with many of our projects, underscore the importance of maintaining a strong financial position. Management views the company's financial strength as a competitive advantage.

In general, segment results are not dependent on the ability to sell and/or purchase products to/from other segments. Instead, where such sales take place, they are the result of efficiencies and competitive advantages of integrated refinery/chemical complexes. Additionally, intersegment sales are at market-based prices. The products bought and sold between segments can also be acquired in worldwide markets that have substantial liquidity, capacity and transportation capabilities. About 59 percent of the company's intersegment sales are crude oil produced by the Upstream and sold to the Downstream. Other intersegment sales include those between refineries and chemical plants related to raw materials, feedstocks and finished products.

Although price levels of crude oil and natural gas may rise or fall significantly over the short to medium term, industry economics over the long term will continue to be driven by market supply and demand. Accordingly, the company tests the viability of all of its investments over a broad range of future prices. The company's assessment is that its operations will continue to be successful in a variety of market conditions. This is the outcome of disciplined investment and asset management programs.

The company has an active asset management program in which underperforming assets are either improved to acceptable levels or considered for divestment. The asset management program includes a disciplined, regular review to ensure that all assets are contributing to the company's strategic objectives. The result is an efficient capital base, and the company has seldom had to write down the carrying value of assets, even during periods of low commodity prices.

Industry bitumen production may be subject to limits on transportation capacity to markets. A significant portion of the company's Upstream production is bitumen. The company's longer-term oil sands development plans, results of operations and cash flow may be adversely affected if, for regulatory or other reasons, necessary additional transportation infrastructure is not added in a timely fashion. The company supports increased market access including proposed pipeline expansions to the United States Gulf coast and the Canadian West coast.

The demand for crude oil, natural gas, petroleum products and petrochemical products correlates closely with general economic growth rates. The occurrence of recessions or other periods of low or negative economic growth will typically have a direct adverse impact on the company's financial results. In challenging economic times, the company follows the proven approach to continue focus on the business elements within its controls and take a long-term view of development.

Increased demand for certain services and materials has resulted in higher capital and other project costs in industry oil sands developments. The company works to counter upward pressure on costs through effective and efficient project and procurement management. One such example is the sanctioning of the Kearl expansion to continue from the initial development such that the initial development's design and development infrastructure can be reused. This continuation also allows the company to retain the experienced labour resources working on the initial development thereby maintaining productivity and limiting cost growth.

To help reduce the risks of dependence on potentially limited supply sources in established, mature conventional producing areas, the company's production is expected to come increasingly from oil sands, unconventional natural gas and tight oil. Technology improvements have played and will continue to play an important role in the economics and the environmental performance of the current and future developments of these unconventional sources.

**Risk management**
The company's size, strong capital structure and the complementary nature of the Upstream, Downstream and Chemical businesses reduce the company's enterprise-wide risk from changes in commodity prices and currency rates. The benefit of integration is demonstrated by the financial results in 2012 when market discounts to Western Canadian crude oil prices negatively impacted the company's Upstream realizations but positively impacted refining margins in the Downstream segment. The company's financial strength and debt capacity give it the opportunity to advance business plans in the pursuit of maximizing shareholder value in the full range of market conditions. Also, the company progresses large capital projects in a phased manner so that adjustments can be made when significant changes in market conditions occur. As a result, the company does not make use of derivative instruments to mitigate the impact of such changes. The company does not engage in speculative derivative activities or derivative trading activities nor does it use derivatives with leveraged features. The company maintains a system of controls that includes a policy covering the authorization, reporting and monitoring of derivative activity.

## Critical accounting estimates

The company's financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP). GAAP requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. The company's accounting and financial reporting fairly reflect its straightforward business model. Imperial does not use financing structures for the purpose of altering accounting outcomes or removing debt from the balance sheet. The company's significant accounting policies are summarized in note 1 to the consolidated financial statements on page A30.

**Oil and gas reserves**
Evaluations of oil and gas reserves are important to the effective management of Upstream assets. They are integral to making investment decisions about oil and gas properties such as whether development should proceed. Oil and gas reserve quantities are also used as the basis for calculating unit-of-production depreciation rates and for evaluating impairment.

Oil and gas reserves include both proved and unproved reserves. Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible. Unproved reserves are those with less than reasonable certainty of recoverability and include probable reserves. Probable reserves are reserves that are more likely to be recovered than not.

The estimation of proved reserves is an ongoing process based on rigorous technical evaluations, commercial and market assessment, and detailed analysis of well information such as flow rates and reservoir pressure declines. The estimation of proved reserves is controlled by the company through long-standing approval guidelines. Reserve changes are made within a well-established, disciplined process driven by senior level geoscience and engineering professionals, assisted by the reserves management group which has significant technical experience, culminating in reviews with and approval by senior management and the company's board of directors. Notably, the company does not use specific quantitative reserve targets to determine compensation. Key features of the reserve estimation process are covered in Disclosure of Reserves in Item 1.

Although the company is reasonably certain that proved reserves will be produced, the timing and amount recovered can be affected by a number of factors, including completion of development projects, reservoir performance, regulatory approvals and significant changes in long-term oil and gas price levels.

Revisions can include upward or downward changes in previously estimated volumes of proved reserves for existing fields due to the evaluation or revaluation of already available geologic, reservoir or production data; new geologic, reservoir or production data; or changes in prices and year-end costs that are used in the estimation of reserves. Revisions can also result from significant changes in either development strategy or production equipment/facility capacity.

***Impact of oil and gas reserves on depreciation***

The calculation of unit-of-production depreciation is a critical accounting estimate that measures the depreciation of upstream assets. It is the ratio of actual volumes produced to total proved developed reserves (those reserves recoverable through existing wells with existing equipment and operating methods) applied to the asset cost. The volumes produced and asset cost are known and, while proved developed reserves have a high probability of recoverability, they are based on estimates that are subject to some variability. While the revisions the company has made in the past are an indicator of variability, they have had little impact on the unit-of-production rates of depreciation.

***Impact of oil and gas reserves and prices on testing for impairment***

Proved oil and gas properties held and used by the company are reviewed for impairment whenever events or circumstances indicate that the carrying amounts may not be recoverable. Assets are grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

The company estimates the future undiscounted cash flows of the affected properties to judge the recoverability of carrying amounts. Impairment analyses are generally based on reserve estimates used for internal planning and capital investment decisions. Where probable reserves exist, an appropriately risk-adjusted amount of these reserves may be included in the impairment evaluation. An asset group would be impaired if its undiscounted cash flows were less than the asset's carrying value. Impairments are measured by the amount by which the carrying value exceeds fair value.

Significant unproved properties are assessed for impairment individually, and valuation allowances against the capitalized costs are recorded based on the estimated economic chance of success and the length of time that the company expects to hold the properties. Properties that are not individually significant are aggregated by groups and amortized based on development risk and average holding period.

The company performs asset valuation analyses on an ongoing basis as a part of its asset management program. These analyses assist the company in assessing whether the carrying amounts of any of its assets may not be recoverable. In addition to estimating oil and gas reserve volumes in conducting these analyses, it is also necessary to estimate future oil and gas prices. Potential trigger events for impairment evaluations include a significant decrease in current and projected reserve volumes, an accumulation of project costs significantly in excess of the amount originally expected, and current period operating losses combined with a history or forecast of operating or cash flow losses.

## **Management's discussion and analysis of financial condition and results of operations** (continued)

In general, the company does not view temporarily low prices or margins as a triggering event for conducting the impairment tests. The markets for crude oil and natural gas have a history of significant price volatility. Although prices will occasionally drop significantly, the relative growth/decline in supply versus demand will determine industry prices over the long term, and these cannot be accurately predicted. Accordingly, any impairment tests that the company performs make use of the company's price assumptions developed in the annual planning and budgeting process for the crude oil and natural gas markets, petroleum products and chemicals. These are the same price assumptions that are used for capital investment decisions. Volumes are based on field production profiles, which are also updated annually.

Supplemental information regarding oil and gas results of operations, capitalized costs and reserves is provided following the notes to the consolidated financial statements. Future prices used for any impairment tests will vary from the one used in the supplemental oil and gas disclosure and could be lower or higher for any given year.

**Pension benefits**
The company's pension plan is managed in compliance with the requirements of governmental authorities and meets funding levels as determined by independent third-party actuaries. Pension accounting requires explicit assumptions regarding, among others, the discount rate for the benefit obligations, the expected rate of return on plan assets and the long-term rate of future compensation increases. All pension assumptions are reviewed annually by senior management. These assumptions are adjusted only as appropriate to reflect long-term changes in market rates and outlook. The long-term expected rate of return on plan assets of 6.25 percent used in 2012 compares to actual returns of 7.3 percent and 8.5 percent achieved over the last 10- and 20-year periods ending December 31, 2012. If different assumptions are used, the expense and obligations could increase or decrease as a result. The company's potential exposure to changes in assumptions is summarized in note 4 to the consolidated financial statements on page A36. At Imperial, differences between actual returns on plan assets and the long-term expected returns are not recorded in pension expense in the year the differences occur. Such differences are deferred, along with other actuarial gains and losses, and are amortized into pension expense over the expected average remaining service life of employees. Employee benefit expense represented less than two percent of total expenses in 2012.

**Asset retirement obligations and other environmental liabilities**
Legal obligations associated with site restoration on the retirement of assets with determinable useful lives are recognized when they are incurred, which is typically at the time the assets are installed. The obligations are initially measured at fair value and discounted to present value. Over time, the discounted asset retirement obligation amount will be accreted for the change in its present value, with this effect included in production and manufacturing expenses. As payments to settle the obligations occur on an ongoing basis and will continue over the lives of the operating assets, which can exceed 25 years, the discount rate will be adjusted only as appropriate to reflect long-term changes in market rates and outlook. For 2012, the obligations were discounted at six percent and the accretion expense was $86 million, before tax, which was significantly less than one percent of total expenses in the year. There would be no material impact on the company's reported financial results if a different discount rate had been used.

Asset retirement obligations are not recognized for assets with an indeterminate useful life. Asset retirement obligations for these facilities generally become firm at the time the facilities are permanently shut down and dismantled. These obligations may include the costs of asset disposal and additional soil remediation. However, these sites have indeterminate lives based on plans for continued operations, and as such, the fair value of the conditional legal obligations cannot be measured, since it is impossible to estimate the future settlement dates of such obligations. For these and non-operating assets, the company accrues provisions for environmental liabilities when it is probable that obligations have been incurred and the amount can be reasonably estimated.

Asset retirement obligations and other environmental liabilities are based on engineering estimated costs, taking into account the anticipated method and extent of remediation consistent with legal requirements, current technology and the possible use of the location. Since these estimates are specific to the locations involved, there are many individual assumptions underlying the company's total asset retirement obligations and provision for other environmental liabilities. While these individual assumptions can be subject to change, none of them is individually significant to the company's reported financial results.

### Suspended exploratory well costs

The company continues capitalization of exploratory well costs when the well has found a sufficient quantity of reserves to justify its completion as a producing well and the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. Exploratory well costs not meeting these criteria are charged to expense. The facts and circumstances that support continued capitalization of suspended wells as of year-end 2012 are disclosed in note 15 to the consolidated financial statements.

### Tax contingencies

The operations of the company are complex, and related tax interpretations, regulations and legislation are continually changing. Significant management judgment is required in the accounting for income tax contingencies and tax disputes because the outcomes are often difficult to predict.

The benefits of uncertain tax positions that the company has taken or expects to take in its income tax returns are recognized in the financial statements if management concludes that it is more likely than not that the position will be sustained with the tax authorities. For a position that is likely to be sustained, the benefit recognized in the financial statements is measured at the largest amount that is greater than 50 percent likely of being realized. A reserve is established for the difference between a position taken or expected to be taken in an income tax return and the amount recognized in the financial statements. The company's unrecognized tax benefits and a description of open tax years are summarized in note 3 to the consolidated financial statements on page A35.

# Management's report on internal control over financial reporting

Management, including the company's chief executive officer and principal accounting officer and principal financial officer, is responsible for establishing and maintaining adequate internal control over the company's financial reporting. Management conducted an evaluation of the effectiveness of internal control over financial reporting based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that Imperial Oil Limited's internal control over financial reporting was effective as of December 31, 2012.

PricewaterhouseCoopers LLP, an independent registered public accounting firm, audited the effectiveness of the company's internal control over financial reporting as of December 31, 2012, as stated in their report which is included herein.

*/s/* Bruce H. March

B.H. March
Chairman, president and
chief executive officer

*/s/* Paul J. Masschelin

P.J. Masschelin
Senior vice-president,
finance and administration, and controller
(Principal accounting officer and principal financial officer)

February 26, 2013

# Report of independent registered public accounting firm

**To the Shareholders of Imperial Oil Limited**

We have audited the accompanying consolidated balance sheet of Imperial Oil Limited as of December 31, 2012 and December 31, 2011 and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2012. We also have audited Imperial Oil Limited's internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management's report on internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the company's internal control over financial reporting based on our integrated audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall consolidated financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Imperial Oil Limited as of December 31, 2012 and December 31, 2011 and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2012 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Imperial Oil Limited maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control - Integrated Framework issued by the COSO.

*/s/* PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta, Canada
February 26, 2013

# Consolidated statement of income (U.S. GAAP)

| millions of Canadian dollars<br>For the years ended December 31 | **2012** | 2011 | 2010 |
|---|---|---|---|
| **Revenues and other income** | | | |
| Operating revenues (a)(b) | **31,053** | 30,474 | 24,946 |
| Investment and other income (note 8) | **135** | 240 | 146 |
| **Total revenues and other income** | **31,188** | 30,714 | 25,092 |
| | | | |
| **Expenses** | | | |
| Exploration | **83** | 92 | 191 |
| Purchases of crude oil and products (c) | **18,476** | 18,847 | 14,811 |
| Production and manufacturing (d) | **4,457** | 4,114 | 3,996 |
| Selling and general | **1,081** | 1,168 | 1,070 |
| Federal excise tax (a) | **1,338** | 1,320 | 1,316 |
| Depreciation and depletion | **761** | 764 | 747 |
| Financing costs (note 12) | **(1)** | 3 | 7 |
| **Total expenses** | **26,195** | 26,308 | 22,138 |
| | | | |
| **Income before income taxes** | **4,993** | 4,406 | 2,954 |
| | | | |
| **Income taxes** (note 3) | **1,227** | 1,035 | 744 |
| | | | |
| **Net income** | **3,766** | 3,371 | 2,210 |
| | | | |
| **Per-share information** (Canadian dollars) | | | |
| Net income per common share - basic (note 10) | **4.44** | 3.98 | 2.61 |
| Net income per common share - diluted (note 10) | **4.42** | 3.95 | 2.59 |
| Dividends | **0.48** | 0.44 | 0.43 |

(a) Operating revenues include federal excise tax of $1,338 million (2011 - $1,320 million, 2010 - $1,316 million).
(b) Operating revenues include amounts from related parties of $2,907 million (2011 - $2,818 million, 2010 - $2,250 million), (note 16).
(c) Purchases of crude oil and products include amounts from related parties of $3,033 million (2011 - $3,636 million, 2010 - $2,828 million), (note 16).
(d) Production and manufacturing expenses include amounts to related parties of $241 million (2011 - $217 million, 2010 - $233 million), (note 16).

The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

# Consolidated statement of comprehensive income (U.S. GAAP)

| millions of Canadian dollars<br>For the years ended December 31 | **2012** | 2011 | 2010 |
|---|---|---|---|
| **Net income** | **3,766** | 3,371 | 2,210 |
| | | | |
| Other comprehensive income, net of income taxes (note 4) | | | |
| Post-retirement benefits liability adjustment (excluding amortization) | **(415)** | (953) | (217) |
| Amortization of post-retirement benefits liability adjustment included in net periodic benefit costs | **198** | 139 | 114 |
| **Total other comprehensive income/(loss)** | **(217)** | (814) | (103) |
| | | | |
| **Comprehensive income** | **3,549** | 2,557 | 2,107 |

The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

# Consolidated balance sheet (U.S. GAAP)

| millions of Canadian dollars<br>At December 31 | **2012** | 2011 |
|---|---|---|
| **Assets** | | |
| Current Assets | | |
| Cash | **482** | 1,202 |
| Accounts receivable, less estimated doubtful amounts | **1,976** | 2,290 |
| Inventories of crude oil and products (note 11) | **827** | 762 |
| Materials, supplies and prepaid expenses | **280** | 239 |
| Deferred income tax assets (note 3) | **527** | 590 |
| Total current assets | **4,092** | 5,083 |
| Long-term receivables, investments and other long-term assets | **1,090** | 920 |
| Property, plant and equipment, less accumulated depreciation and depletion (note 2) | **23,922** | 19,162 |
| Goodwill (note 2) | **204** | 204 |
| Other intangible assets, net | **56** | 60 |
| **Total assets** (note 2) | **29,364** | 25,429 |
| | | |
| **Liabilities** | | |
| Current liabilities | | |
| Notes and loans payable | **472** | 364 |
| Accounts payable and accrued liabilities (a) (note 11) | **4,249** | 4,317 |
| Income taxes payable | **1,184** | 1,268 |
| Total current liabilities | **5,905** | 5,949 |
| Long-term debt (b)(note 14) | **1,175** | 843 |
| Other long-term obligations (note 5) | **3,983** | 3,876 |
| Deferred income tax liabilities (note 3) | **1,924** | 1,440 |
| **Total liabilities** | **12,987** | 12,108 |
| | | |
| Commitments and contingent liabilities (note 9) | | |
| | | |
| **Shareholders' equity** | | |
| Common shares at stated value (c)(note 10) | **1,566** | 1,528 |
| Earnings reinvested | **17,266** | 14,031 |
| Accumulated other comprehensive income | **(2,455)** | (2,238) |
| **Total shareholders' equity** | **16,377** | 13,321 |
| | | |
| **Total liabilities and shareholders' equity** | **29,364** | 25,429 |

(a) Accounts payable and accrued liabilities include amounts receivable from related parties of $9 million (2011 – amounts payable of $215 million), (note 16).
(b) Long-term debt includes amounts to related parties of $1,040 million (2011 – $820 million).
(c) Number of common shares outstanding was 848 million (2011 - 848 million), (note 10).
The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

Approved by the directors

*/s/ Bruce H. March*

B.H. March
Chairman, president and
chief executive officer

*/s/ Paul J. Masschelin*

P.J. Masschelin
Senior vice-president,
finance and administration, and controller

# Consolidated statement of shareholders' equity (U.S. GAAP)

| millions of Canadian dollars<br>At December 31 | **2012** | 2011 | 2010 |
|---|---|---|---|
| **Common shares at stated value** (note 10) | | | |
| At beginning of year | **1,528** | 1,511 | 1,508 |
| Issued under the stock option plan | **43** | 19 | 3 |
| Share purchases at stated value | **(5)** | (2) | - |
| At end of year | **1,566** | 1,528 | 1,511 |
| | | | |
| **Earnings reinvested** | | | |
| At beginning of year | **14,031** | 11,090 | 9,252 |
| Net income for the year | **3,766** | 3,371 | 2,210 |
| Share purchases in excess of stated value | **(123)** | (57) | (8) |
| Dividends | **(408)** | (373) | (364) |
| At end of year | **17,266** | 14,031 | 11,090 |
| | | | |
| **Accumulated other comprehensive income** | | | |
| At beginning of year | **(2,238)** | (1,424) | (1,321) |
| Other comprehensive income | **(217)** | (814) | (103) |
| At end of year | **(2,455)** | (2,238) | (1,424) |
| | | | |
| **Shareholders' equity at end of year** | **16,377** | 13,321 | 11,177 |

The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

# Consolidated statement of cash flows (U.S. GAAP)

| millions of Canadian dollars<br>Inflow/(outflow)<br>For the years ended December 31 | **2012** | 2011 | 2010 |
|---|---|---|---|
| **Operating activities** | | | |
| Net income | **3,766** | 3,371 | 2,210 |
| Adjustments for non-cash items: | | | |
| Depreciation and depletion | **761** | 764 | 747 |
| (Gain)/loss on asset sales | **(94)** | (197) | (95) |
| Deferred income taxes and other | **619** | 71 | 152 |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | **300** | (302) | (289) |
| Inventories, materials, supplies and prepaid expenses | **(106)** | (228) | 38 |
| Income taxes payable | **(84)** | 390 | 30 |
| Accounts payable and accrued liabilities | **(67)** | 846 | 651 |
| All other items - net (a) | **(415)** | (226) | (237) |
| **Cash flows from (used in) operating activities** | **4,680** | 4,489 | 3,207 |
| | | | |
| **Investing activities** | | | |
| Additions to property, plant and equipment | **(5,478)** | (3,919) | (3,856) |
| Proceeds from asset sales | **226** | 314 | 144 |
| Repayment of loan from equity company | **14** | 12 | 3 |
| **Cash flows from (used in) investing activities** | **(5,238)** | (3,593) | (3,709) |
| | | | |
| **Financing activities** | | | |
| Short-term debt - net | **105** | 135 | 120 |
| Long-term debt issued | **220** | 320 | 500 |
| Reduction in capitalized lease obligations | **(4)** | (3) | (3) |
| Issuance of common shares under stock option plan | **43** | 19 | 3 |
| Common shares purchased (note 10) | **(128)** | (59) | (8) |
| Dividends paid | **(398)** | (373) | (356) |
| **Cash flows from (used in) financing activities** | **(162)** | 39 | 256 |
| | | | |
| **Increase (decrease) in cash** | **(720)** | 935 | (246) |
| **Cash at beginning of year** | **1,202** | 267 | 513 |
| **Cash at end of year** (b) | **482** | 1,202 | 267 |

(a) Includes contribution to registered pension plans of $594 million (2011 - $361 million, 2010 - $421 million).

(b) Cash is composed of cash in bank and cash equivalents at cost. Cash equivalents are all highly liquid securities with maturity of three months or less when purchased.

The information in the Notes to Consolidated Financial Statements is an integral part of these statements.

# Notes to consolidated financial statements

The accompanying consolidated financial statements and the supporting and supplemental material are the responsibility of the management of Imperial Oil Limited.

The company's principal business is energy, involving the exploration, production, transportation and sale of crude oil and natural gas and the manufacture, transportation and sale of petroleum products. The company is also a major manufacturer and marketer of petrochemicals.

The consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP). GAAP requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Certain reclassifications to prior years have been made to conform to the 2012 presentation. All amounts are in Canadian dollars unless otherwise indicated.

## 1. Summary of significant accounting policies

**Principles of consolidation**
The consolidated financial statements include the accounts of subsidiaries the company controls. Intercompany accounts and transactions are eliminated. Subsidiaries include those companies in which Imperial has both an equity interest and the continuing ability to unilaterally determine strategic, operating, investing and financing policies. Significant subsidiaries included in the consolidated financial statements include Imperial Oil Resources Limited, Imperial Oil Resources N.W.T. Limited, Imperial Oil Resources Ventures Limited and McColl-Frontenac Petroleum Inc. All of the above companies are wholly owned. The consolidated financial statements also include the company’s share of the undivided interest in certain upstream assets and liabilities, including its 25 percent interest in the Syncrude joint venture and its 70.96 percent interest in the Kearl project.

**Inventories**
Inventories are recorded at the lower of cost or current market value. The cost of crude oil and products is determined primarily using the last-in, first-out (LIFO) method. LIFO was selected over the alternative first-in, first-out and average cost methods because it provides a better matching of current costs with the revenues generated in the period.

Inventory costs include expenditures and other charges, including depreciation, directly or indirectly incurred in bringing the inventory to its existing condition and final storage prior to delivery to a customer. Selling and general expenses are reported as period costs and excluded from inventory costs.

**Investments**
The company’s interests in the underlying net assets of affiliates it does not control, but over which it exercises significant influence, are accounted for using the equity method. They are recorded at the original cost of the investment plus Imperial’s share of earnings since the investment was made, less dividends received. Imperial’s share of the after-tax earnings of these companies is included in “investment and other income” in the consolidated statement of income. Other investments are recorded at cost. Dividends from these other investments are included in “investment and other income.”

These investments represent interests in non-publicly traded pipeline companies that facilitate the sale and purchase of liquids in the conduct of company operations. Other parties who also have an equity interest in these companies share in the risks and rewards according to their percentage of ownership. Imperial does not invest in these companies in order to remove liabilities from its balance sheet.

**Property, plant and equipment**
Property, plant and equipment are recorded at cost. Investment tax credits and other similar grants are treated as a reduction of the capitalized cost of the asset to which they apply.

The company uses the successful-efforts method to account for its exploration and development activities. Under this method, costs are accumulated on a field-by-field basis with certain exploratory expenditures and exploratory dry holes being expensed as incurred. Costs of productive wells and development dry holes are capitalized and amortized using the unit-of-production method. The company carries as an asset exploratory well costs when the well has found a sufficient quantity of reserves to justify its completion as a producing well and where the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. Other exploratory expenditures, including geophysical costs and annual lease rentals are expensed as incurred.

Maintenance and repair costs, including planned major maintenance, are expensed as incurred. Improvements that increase or prolong the service life or capacity of an asset are capitalized.

Production costs are expensed as incurred. Production involves lifting the oil and gas to the surface and gathering, treating, field processing and field storage of the oil and gas. The production function normally terminates at the outlet valve on the lease or field production storage tank. Production costs are those incurred to operate and maintain the company's wells and related equipment and facilities. They become part of the cost of oil and gas produced. These costs, sometimes referred to as lifting costs, include such items as labour cost to operate the wells and related equipment; repair and maintenance costs on the wells and equipment; materials, supplies and energy costs required to operate the wells and related equipment; and administrative expenses related to the production activity.

Acquisition costs of proved properties are amortized using a unit-of-production method, computed on the basis of total proved oil and gas reserves. Depreciation and depletion for assets associated with producing properties begin at the time when production commences on a regular basis. Depreciation for other assets begins when the asset is in place and ready for its intended use. Assets under construction are not depreciated or depleted. Unit-of-production depreciation is applied to those wells, plant and equipment assets associated with productive depletable properties, and the unit-of-production rates are based on the amount of proved developed reserves of oil and gas. Depreciation of other plant and equipment is calculated using the straight-line method, based on the estimated service life of the asset. In general, refineries are depreciated over 25 years; other major assets, including chemical plants and service stations, are depreciated over 20 years.

Proved oil and gas properties held and used by the company are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. Assets are grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

The company estimates the future undiscounted cash flows of the affected properties to judge the recoverability of carrying amounts. Cash flows used in impairment evaluations are developed using annually updated corporate plan investment evaluation assumptions for crude oil and natural gas commodity prices and foreign-currency exchange rates. Annual volumes are based on field production profiles, which are also updated annually.

Impairment analyses are generally based on reserve estimates used for internal planning and capital investment decisions. Where probable reserves exist, an appropriately risk-adjusted amount of these reserves may be included in the impairment evaluation. An asset group would be impaired if the undiscounted cash flows were less than its carrying value. Impairments are measured by the amount the carrying value exceeds fair value.

Significant unproved properties are assessed for impairment individually and valuation allowances against the capitalized costs are recorded based on the estimated economic chance of success and the length of time the company expects to hold the properties. Properties that are not individually significant are aggregated by groups and amortized based on development risk and average holding period. The valuation allowances are reviewed at least annually.

Gains or losses on assets sold are included in "investment and other income" in the consolidated statement of income.

**Interest capitalization**
Interest costs relating to major capital projects under construction are capitalized as part of property, plant and equipment. The project construction phase commences with the development of the detailed engineering design and ends when the constructed assets are ready for their intended use.

## Notes to consolidated financial statements (continued)

**Goodwill and other intangible assets**
Goodwill is not subject to amortization. Goodwill is tested for impairment annually or more frequently if events or circumstances indicate it might be impaired. Impairment losses are recognized in current period earnings. The evaluation for impairment of goodwill is based on a comparison of the carrying values of goodwill and associated operating assets with the estimated present value of net cash flows from those operating assets.

Intangible assets with determinable useful lives are amortized over the estimated service lives of the assets. Computer software development costs are amortized over a maximum of 15 years and customer lists are amortized over a maximum of 10 years. The amortization is included in “depreciation and depletion” in the consolidated statement of income.

**Asset retirement obligations and other environmental liabilities**
Legal obligations associated with site restoration on the retirement of assets with determinable useful lives are recognized when they are incurred, which is typically at the time the assets are installed. These obligations primarily relate to soil reclamation and remediation and costs of abandonment and demolition of oil and gas wells and related facilities. The company uses estimates, assumptions and judgments regarding such factors as the existence of a legal obligation for an asset retirement obligation, technical assessments of the assets, estimated amounts and timing of settlements, the credit-adjusted risk-free rate to be used, and inflation rates. The obligations are initially measured at fair value and discounted to present value. A corresponding amount equal to that of the initial obligation is added to the capitalized costs of the related asset. Over time, the discounted asset retirement obligation amount will be accreted for the change in its present value, and the initial capitalized costs will be depreciated over the useful lives of the related assets.

No asset retirement obligations are set up for those manufacturing, distribution and marketing facilities with an indeterminate useful life. Asset retirement obligations for these facilities generally become firm at the time the facilities are permanently shut down and dismantled. These obligations may include the costs of asset disposal and additional soil remediation. However, these sites have indeterminate lives based on plans for continued operations, and as such, the fair value of the conditional legal obligations cannot be measured, since it is impossible to estimate the future settlement dates of such obligations. Provision for environmental liabilities of these assets is made when it is probable that obligations have been incurred and the amount can be reasonably estimated. Provisions for environmental liabilities are determined based on engineering estimated costs, taking into account the anticipated method and extent of remediation consistent with legal requirements, current technology and the possible use of the location. These liabilities are not discounted.

**Foreign-currency translation**
Monetary assets and liabilities in foreign currencies have been translated at the rates of exchange prevailing on December 31. Any exchange gains or losses are recognized in income.

**Fair value**
Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Hierarchy Levels 1, 2 or 3 are terms for the priority of inputs to valuation techniques used to measure fair value. Hierarchy Level 1 inputs are quoted prices in active markets for identical assets or liabilities. Hierarchy Level 2 inputs are inputs other than quoted prices included within Level 1 that are directly or indirectly observable for the asset or liability. Hierarchy Level 3 inputs are inputs that are not observable in the market.

**Revenues**
Revenues associated with sales of crude oil, natural gas, petroleum and chemical products and other items are recorded when the products are delivered. Delivery occurs when the customer has taken title and has assumed the risks and rewards of ownership, prices are fixed or determinable and collectability is reasonably assured. The company does not enter into ongoing arrangements whereby it is required to repurchase its products, nor does the company provide the customer with a right of return.

Revenues include amounts billed to customers for shipping and handling. Shipping and handling costs incurred up to the point of final storage prior to delivery to a customer are included in “purchases of crude oil and products” in the consolidated statement of income. Delivery costs from final storage to customer are recorded as a marketing expense in "selling and general" expenses.

Purchases and sales of inventory with the same counterparty that are entered into in contemplation of one another are combined and recorded as exchanges measured at the book value of the item sold.

**Share-based compensation**

The company awards share-based compensation to certain employees in the form of restricted stock units. Compensation expense is measured each reporting period based on the company's current stock price and is recorded as "selling and general" expenses in the consolidated statement of income over the requisite service period of each award. See note 7 to the consolidated financial statements on page A42 for further details.

**Consumer taxes**

Taxes levied on the consumer and collected by the company are excluded from the consolidated statement of income. These are primarily provincial taxes on motor fuels, the federal goods and services tax and the federal/provincial harmonized sales tax.

## 2. Business segments

The company operates its business in Canada. The Upstream, Downstream and Chemical functions best define the operating segments of the business that are reported separately. The factors used to identify these reportable segments are based on the nature of the operations that are undertaken by each segment and the structure of the company's internal organization. The Upstream segment is organized and operates to explore for and ultimately produce crude oil and its equivalent, and natural gas. The Downstream segment is organized and operates to refine crude oil into petroleum products and the distribution and marketing of these products. The Chemical segment is organized and operates to manufacture and market hydrocarbon-based chemicals and chemical products. The above segmentation has been the long-standing practice of the company and is broadly understood across the petroleum and petrochemical industries.

These functions have been defined as the operating segments of the company because they are the segments (a) that engage in business activities from which revenues are earned and expenses are incurred; (b) whose operating results are regularly reviewed by the company's chief operating decision maker to make decisions about resources to be allocated to each segment and assess its performance; and (c) for which discrete financial information is available.

Corporate and other includes assets and liabilities that do not specifically relate to business segments – primarily cash, capitalized interest costs, short-term borrowings, long-term debt and liabilities associated with incentive compensation and post-retirement benefits liability adjustment. Net income in this segment primarily includes financing costs, interest income and share-based incentive compensation expenses.

Segment accounting policies are the same as those described in the summary of significant accounting policies. Upstream, Downstream and Chemical expenses include amounts allocated from the Corporate and other segment. The allocation is based on a combination of fee for service, proportional segment expenses and a three-year average of capital expenditures. Transfers of assets between segments are recorded at book amounts. Intersegment sales are made essentially at prevailing market prices. Assets and liabilities that are not identifiable by segment are allocated.

| millions of dollars | Upstream 2012 | Upstream 2011 | Upstream 2010 | Downstream 2012 | Downstream 2011 | Downstream 2010 | Chemical 2012 | Chemical 2011 | Chemical 2010 |
|---|---|---|---|---|---|---|---|---|---|
| **Revenues and other income** | | | | | | | | | |
| Operating revenues (a) | **4,674** | 5,278 | 4,283 | **25,077** | 23,909 | 19,565 | **1,302** | 1,287 | 1,098 |
| Intersegment sales | **4,110** | 4,460 | 3,802 | **2,603** | 2,784 | 1,973 | **299** | 354 | 285 |
| Investment and other income | **46** | 168 | 59 | **81** | 63 | 81 | **-** | - | 3 |
| | **8,830** | 9,906 | 8,144 | **27,761** | 26,756 | 21,619 | **1,601** | 1,641 | 1,386 |
| **Expenses** | | | | | | | | | |
| Exploration | **83** | 92 | 191 | **-** | - | - | **-** | - | - |
| Purchases of crude oil and products | **3,056** | 3,581 | 2,692 | **21,316** | 21,642 | 17,169 | **1,115** | 1,222 | 1,009 |
| Production and manufacturing | **2,704** | 2,484 | 2,375 | **1,569** | 1,451 | 1,413 | **185** | 179 | 209 |
| Selling and general (b) | **1** | 7 | 5 | **935** | 973 | 918 | **67** | 64 | 63 |
| Federal excise tax | **-** | - | - | **1,338** | 1,320 | 1,316 | **-** | - | - |
| Depreciation and depletion | **498** | 528 | 514 | **242** | 214 | 213 | **12** | 13 | 12 |
| Financing costs (note 12) | **(1)** | 2 | 3 | **-** | (1) | 1 | **-** | - | - |
| **Total expenses** | **6,341** | 6,694 | 5,780 | **25,400** | 25,599 | 21,030 | **1,379** | 1,478 | 1,293 |
| **Income before income taxes** | **2,489** | 3,212 | 2,364 | **2,361** | 1,157 | 589 | **222** | 163 | 93 |
| **Income taxes** (note 3) | | | | | | | | | |
| Current | **72** | 593 | 477 | **486** | 372 | 141 | **67** | 43 | 18 |
| Deferred | **529** | 162 | 123 | **103** | (99) | 6 | **(10)** | (2) | 6 |
| **Total income tax expense** | **601** | 755 | 600 | **589** | 273 | 147 | **57** | 41 | 24 |
| **Net income** | **1,888** | 2,457 | 1,764 | **1,772** | 884 | 442 | **165** | 122 | 69 |
| **Cash flows from (used in) operating activities** | **2,625** | 3,252 | 2,494 | **1,961** | 1,315 | 787 | **127** | 53 | 65 |
| **Capital and exploration expenditures** (c) | **5,518** | 3,880 | 3,844 | **140** | 166 | 184 | **4** | 4 | 10 |
| **Property, plant and equipment** | | | | | | | | | |
| Cost | **30,602** | 25,327 | 21,990 | **7,038** | 6,990 | 6,933 | **765** | 760 | 758 |
| Accumulated depreciation and depletion | **(10,146)** | (9,747) | (9,740) | **(3,967)** | (3,803) | (3,678) | **(576)** | (560) | (546) |
| **Net property, plant and equipment** (d) | **20,456** | 15,580 | 12,250 | **3,071** | 3,187 | 3,255 | **189** | 200 | 212 |
| **Total assets** (e) | **22,317** | 17,222 | 13,852 | **6,409** | 6,700 | 6,315 | **372** | 397 | 425 |

| millions of dollars | Corporate and other 2012 | Corporate and other 2011 | Corporate and other 2010 | Eliminations 2012 | Eliminations 2011 | Eliminations 2010 | Consolidated 2012 | Consolidated 2011 | Consolidated 2010 |
|---|---|---|---|---|---|---|---|---|---|
| **Revenues and other income** | | | | | | | | | |
| Operating revenues (a) | **-** | - | - | **-** | - | - | **31,053** | 30,474 | 24,946 |
| Intersegment sales | **-** | - | - | **(7,012)** | (7,598) | (6,060) | **-** | - | - |
| Investment and other income | **8** | 9 | 3 | **-** | - | - | **135** | 240 | 146 |
| | **8** | 9 | 3 | **(7,012)** | (7,598) | (6,060) | **31,188** | 30,714 | 25,092 |
| **Expenses** | | | | | | | | | |
| Exploration | **-** | - | - | **-** | - | - | **83** | 92 | 191 |
| Purchases of crude oil and products | **-** | - | - | **(7,011)** | (7,598) | (6,059) | **18,476** | 18,847 | 14,811 |
| Production and manufacturing | **-** | - | - | **(1)** | - | (1) | **4,457** | 4,114 | 3,996 |
| Selling and general (b) | **78** | 124 | 84 | **-** | - | - | **1,081** | 1,168 | 1,070 |
| Federal excise tax | **-** | - | - | **-** | - | - | **1,338** | 1,320 | 1,316 |
| Depreciation and depletion | **9** | 9 | 8 | **-** | - | - | **761** | 764 | 747 |
| Financing costs (note 12) | **-** | 2 | 3 | **-** | - | - | **(1)** | 3 | 7 |
| **Total expenses** | **87** | 135 | 95 | **(7,012)** | (7,598) | (6,060) | **26,195** | 26,308 | 22,138 |
| **Income before income taxes** | **(79)** | (126) | (92) | **-** | - | - | **4,993** | 4,406 | 2,954 |
| **Income taxes** (note 3) | | | | | | | | | |
| Current | **(32)** | (53) | (47) | **-** | - | - | **593** | 955 | 589 |
| Deferred | **12** | 19 | 20 | **-** | - | - | **634** | 80 | 155 |
| **Total income tax expense** | **(20)** | (34) | (27) | **-** | - | - | **1,227** | 1,035 | 744 |
| **Net income** | **(59)** | (92) | (65) | **-** | - | - | **3,766** | 3,371 | 2,210 |
| **Cash flows from (used in) operating activities** | **(33)** | (131) | (139) | **-** | - | - | **4,680** | 4,489 | 3,207 |
| **Capital and exploration expenditures** (c) | **21** | 16 | 7 | **-** | - | - | **5,683** | 4,066 | 4,045 |
| **Property, plant and equipment** | | | | | | | | | |
| Cost | **360** | 339 | 323 | **-** | - | - | **38,765** | 33,416 | 30,004 |
| Accumulated depreciation and depletion | **(154)** | (144) | (135) | **-** | **-** | - | **(14,843)** | (14,254) | (14,099) |
| **Net property, plant and equipment** (d) | **206** | 195 | 188 | **-** | **-** | - | **23,922** | 19,162 | 15,905 |
| **Total assets** (e) | **704** | 1,418 | 314 | **(438)** | (308) | (326) | **29,364** | 25,429 | 20,580 |

(a) Includes export sales to the United States of $4,358 million (2011- $4,175 million, 2010- $3,650 million). Export sales to the United States were recorded in all operating segments, with the largest effects in the Upstream segment.
(b) Includes delivery costs from final storage areas to customers of $254 million in 2012 (2011 - $286 million, 2010 - $280 million).
(c) Capital and exploration expenditures (CAPEX) include exploration expenses, additions to property, plant, equipment and intangibles and additions to capital leases.
(d) Includes property, plant and equipment under construction of $13,846 million (2011 - $9,147 million).
(e) All goodwill has been assigned to the Downstream segment. There have been no goodwill acquisitions, impairment losses or write-offs due to sales in the past three years. Fair value used in quantitative goodwill impairment tests was Level 3 (unobservable inputs).

## 3. Income taxes

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Current income tax expense | **593** | 955 | 589 |
| Deferred income tax expense (a) | **634** | 80 | 155 |
| Total income tax expense (b) | **1,227** | 1,035 | 744 |
| Statutory corporate tax rate (percent) | **25.5** | 25.4 | 27.0 |
| Increase/(decrease) resulting from: | | | |
| Enacted tax rate change | **-** | - | - |
| Other | **(0.7)** | (1.9) | (1.8) |
| Effective income tax rate | **24.8** | 23.5 | 25.2 |

(a) There were no material net (charges)/credits for the effect of changes in tax laws and rates included in the provisions for deferred income taxes in 2012, 2011 and 2010.
(b) Cash outflow from income taxes, plus investment credits earned, was $871 million in 2012 (2011 – $667 million, 2010 – $603 million).

Income tax (expense)/credit for components of other comprehensive income:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Post-retirement benefits liability adjustment: | | | |
| Post-retirement benefits adjustment (excluding amortization) | **155** | 326 | 74 |
| Amortization of post-retirement benefits liability adjustment included in net periodic benefit cost | **(68)** | (47) | (39) |
| Total post-retirement benefits liability adjustment | **87** | 279 | 35 |

Deferred income taxes are based on differences between the accounting and tax values of assets and liabilities. These differences in value are re-measured at each year-end using the tax rates and tax laws expected to apply when those differences are realized or settled in the future. Components of deferred income tax liabilities and assets as at December 31 were:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Depreciation and amortization | **2,434** | 1,948 | 1,790 |
| Successful drilling and land acquisitions | **399** | 378 | 330 |
| Pension and benefits | **(717)** | (720) | (414) |
| Site restoration | **(284)** | (267) | (224) |
| Capitalized interest | **53** | 50 | 48 |
| Other | **39** | 51 | 16 |
| Deferred income tax liabilities | **1,924** | 1,440 | 1,546 |
| LIFO inventory valuation | **(478)** | (560) | (450) |
| Other | **(49)** | (30) | (48) |
| Deferred income tax assets | **(527)** | (590) | (498) |
| Valuation allowance | **-** | - | - |
| Net deferred income tax liabilities | **1,397** | 850 | 1,048 |

**Unrecognized tax benefits**
Unrecognized tax benefits reflect the difference between positions taken or expected to be taken on tax returns and the amounts recognized in the financial statements. Resolution of the related tax positions will

take many years to complete. It is difficult to predict the timing of resolution for tax positions, since such timing is not entirely within the control of the company. The company's effective tax rate will be reduced if any of these tax benefits are subsequently recognized.

The following table summarizes the movement in unrecognized tax benefits:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| January 1 balance | **134** | 147 | 165 |
| Additions based on current year's tax position | **4** | - | - |
| Additions for prior years' tax positions | **10** | 20 | 24 |
| Reductions for prior years' tax positions | **(3)** | (31) | (37) |
| Reductions due to lapse of the statute of limitations | **(2)** | (2) | (5) |
| December 31 balance | **143** | 134 | 147 |

The 2012, 2011 and 2010 changes in unrecognized tax benefits did not have a material effect on the company's net income or cash flow. The company's tax filings from 2008 to 2011 are subject to examination by the tax authorities. The Canada Revenue Agency has proposed certain adjustments to the company's filings for several years in the period 1994 to 2007. Management is currently evaluating those proposed adjustments. Management believes that a number of outstanding matters before 2008 are expected to be resolved in 2013. The impact on unrecognized tax benefits and the company's effective income tax rate from these matters is not expected to be material.

The company classifies interest on income tax related balances as interest expense or interest income and classifies tax related penalties as operating expense.

## 4. Employee retirement benefits

Retirement benefits, which cover almost all retired employees and their surviving spouses, include pension income and certain health care and life insurance benefits. They are met through funded registered retirement plans and through unfunded supplementary benefits that are paid directly to recipients.

Pension income benefits consist mainly of company-paid defined benefit plans that are based on years of service and final average earnings. The company shares in the cost of health care and life insurance benefits. The company's benefit obligations are based on the projected benefit method of valuation that includes employee service to date and present compensation levels as well as a projection of salaries to retirement.

The expense and obligations for both funded and unfunded benefits are determined in accordance with United States generally accepted accounting principles and actuarial procedures. The process for determining retirement-income expense and related obligations includes making certain long-term assumptions regarding the discount rate, rate of return on plan assets and rate of compensation increases. The obligation and pension expense can vary significantly with changes in the assumptions used to estimate the obligation and the expected return on plan assets.

The benefit obligations and plan assets associated with the company's defined benefit plans are measured on December 31.

| | Pension benefits | | Other post-retirement benefits | |
|---|---|---|---|---|
| | **2012** | 2011 | **2012** | 2011 |
| Assumptions used to determine benefit obligations at December 31 (percent) | | | | |
| Discount rate | **3.75** | 4.25 | **3.75** | 4.25 |
| Long-term rate of compensation increase | **4.50** | 4.50 | **4.50** | 4.50 |
| millions of dollars | | | | |
| **Change in projected benefit obligation** | | | | |
| Projected benefit obligation at January 1 | **6,646** | 5,562 | **508** | 421 |
| Current service cost | **160** | 122 | **8** | 6 |
| Interest cost | **288** | 314 | **21** | 23 |
| Actuarial loss/(gain) | **616** | 897 | **40** | 81 |
| Amendments | **-** | 86 | **-** | - |
| Benefits paid (a) | **(374)** | (335) | **(30)** | (23) |
| Projected benefit obligation at December 31 | **7,336** | 6,646 | **547** | 508 |
| Accumulated benefit obligation at December 31 | **6,560** | 5,970 | | |

The discount rate for calculating year-end post-retirement liabilities is based on the yield for high quality, long-term Canadian corporate bonds at year-end with an average maturity (or duration) approximately that of the liabilities. The measurement of the accumulated post-retirement benefit obligation assumes a health care cost trend rate of 4.50 percent in 2013 and subsequent years.

| | Pension benefits | | Other post-retirement benefits | |
|---|---|---|---|---|
| millions of dollars | **2012** | 2011 | **2012** | 2011 |
| **Change in plan assets** | | | | |
| Fair value at January 1 | **4,461** | 4,296 | | |
| Actual return/(loss) on plan assets | **374** | 93 | | |
| Company contributions | **594** | 361 | | |
| Benefits paid (b) | **(315)** | (289) | | |
| Fair value at December 31 | **5,114** | 4,461 | | |
| Plan assets in excess of/(less than) projected benefit obligation at December 31 | | | | |
| Funded plans | **(1,602)** | (1,595) | | |
| Unfunded plans | **(620)** | (590) | **(547)** | (508) |
| Total (c) | **(2,222)** | (2,185) | **(547)** | (508) |

(a) Benefit payments for funded and unfunded plans.
(b) Benefit payments for funded plans only.
(c) Fair value of assets less projected benefit obligation shown above.

Funding of registered retirement plans complies with federal and provincial pension regulations, and the company makes contributions to the plans based on an independent actuarial valuation. In accordance with authoritative guidance relating to the accounting for defined pension and other post-retirement benefits plans, the underfunded status of the company’s defined benefit post-retirement plans was recorded as a liability in the balance sheet, and the changes in that funded status in the year in which the changes occurred was recognized through other comprehensive income.

| millions of dollars | Pension benefits 2012 | 2011 | Other post-retirement benefits 2012 | 2011 |
|---|---|---|---|---|
| Amounts recorded in the consolidated balance sheet consist of: | | | | |
| Current liabilities | **(24)** | (24) | **(28)** | (24) |
| Other long-term obligations | **(2,198)** | (2,161) | **(519)** | (484) |
| Total recorded | **(2,222)** | (2,185) | **(547)** | (508) |
| | | | | |
| Amounts recorded in accumulated other comprehensive income consist of: | | | | |
| Net actuarial loss/(gain) | **3,210** | 2,916 | **124** | 92 |
| Prior service cost | **85** | 107 | **-** | - |
| Total recorded in accumulated other comprehensive income, before tax | **3,295** | 3,023 | **124** | 92 |

The company establishes the long-term expected rate of return on plan assets by developing a forward-looking long-term return assumption for each asset class, taking into account factors such as the expected real return for the specific asset class and inflation. A single, long-term rate of return is then calculated as the weighted average of the target asset allocation percentages and the long-term return assumption for each asset class. The 2012 long-term expected return of 6.25 percent used in the calculations of pension expense compares to an actual rate of return of 7.3 percent and 8.5 percent over the last 10- and 20-year periods ending December 31, 2012.

| | Pension benefits | | | Other post-retirement benefits | | |
|---|---|---|---|---|---|---|
| | **2012** | 2011 | 2010 | **2012** | 2011 | 2010 |
| Assumptions used to determine net periodic benefit cost for years ended December 31 (percent) | | | | | | |
| Discount rate | **4.25** | 5.50 | 6.25 | **4.25** | 5.50 | 6.25 |
| Long-term rate of return on funded assets | **6.25** | 7.00 | 7.00 | **-** | - | - |
| Long-term rate of compensation increase | **4.50** | 4.50 | 4.50 | **4.50** | 4.50 | 4.50 |
| millions of dollars | | | | | | |
| **Components of net periodic benefit cost** | | | | | | |
| Current service cost | **160** | 122 | 102 | **8** | 6 | 5 |
| Interest cost | **288** | 314 | 307 | **21** | 23 | 24 |
| Expected return on plan assets | **(288)** | (308) | (275) | **-** | - | - |
| Amortization of prior service cost | **23** | 21 | 17 | **-** | - | (1) |
| Recognized actuarial loss/(gain) | **235** | 162 | 137 | **8** | 3 | - |
| Net periodic benefit cost | **418** | 311 | 288 | **37** | 32 | 28 |
| **Changes in amounts recorded in accumulated other comprehensive income** | | | | | | |
| Net actuarial loss/(gain) | **530** | 1,112 | 302 | **40** | 81 | (11) |
| Amortization of net actuarial (loss)/gain included in net periodic benefit cost | **(235)** | (162) | (137) | **(8)** | (3) | - |
| Prior service cost | **-** | 86 | - | **-** | - | - |
| Amortization of prior service cost included in net periodic benefit cost | **(23)** | (21) | (17) | **-** | - | 1 |
| Total recorded in other comprehensive income | **272** | 1,015 | 148 | **32** | 78 | (10) |
| Total recorded in net periodic benefit cost and other comprehensive income, before tax | **690** | 1,326 | 436 | **69** | 110 | 18 |

Costs for defined contribution plans, primarily the employee savings plan, were $36 million in 2012 (2011 - $36 million, 2010 - $37 million).

A summary of the change in accumulated other comprehensive income is shown in the table below:

| millions of dollars | Total pension and other post-retirement benefits **2012** | 2011 | 2010 |
|---|---|---|---|
| (Charge)/credit to other comprehensive income, before tax | **(304)** | (1,093) | (138) |
| Deferred income tax (charge)/credit (note 3) | **87** | 279 | 35 |
| (Charge)/credit to other comprehensive income, after tax | **(217)** | (814) | (103) |

The company's investment strategy for pension plan assets reflects a long-term view, a careful assessment of the risks inherent in various asset classes and broad diversification to reduce the risk of the portfolio. Consistent with the long-term nature of the liability, the plan assets are primarily invested in global, market-cap-weighted indexed equity and domestic indexed bond funds to diversify risk while minimizing costs. The equity funds hold Imperial Oil stock only to the extent necessary to replicate the relevant equity index. The balance of the plan assets is largely invested in high-quality corporate and government debt securities. Studies are periodically conducted to establish the preferred target asset allocation. The target asset allocation for equity securities is 46 percent. The target allocation for debt securities is 49 percent. Plan assets for the remaining 5 percent are invested in venture capital partnerships that pursue a strategy of investment in U.S. and international early stage ventures.

The 2012 fair value of the pension plan assets, including the level within the fair value hierarchy, is shown in the table below:

| millions of dollars | Total | Fair value measurements at December 31, 2012, using: Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | | Significant unobservable inputs (Level 3) | |
|---|---|---|---|---|---|---|
| Asset class | | | | | | |
| Equity securities | | | | | | |
| Canadian | 811 | | 811 | (a) | | |
| Non-Canadian | 1,657 | | 1,657 | (a) | | |
| Debt securities - Canadian | | | | | | |
| Corporate | 473 | | 473 | (b) | | |
| Government | 1,982 | | 1,982 | (b) | | |
| Asset backed | 5 | | 5 | (b) | | |
| Mortgage funds | 1 | | | | 1 | (c) |
| Equities – Venture capital | 158 | | | | 158 | (d) |
| Cash | 27 | 9 | 18 | (e) | | |
| Total plan assets at fair value | 5,114 | 9 | 4,946 | | 159 | |

(a) For company equity securities held in the form of fund units that are redeemable at the measurement date, the unit value is treated as a Level 2 input. The fair value of the securities owned by the funds is based on observable quoted prices on active exchanges, which are Level 1 inputs.

(b) For corporate, government and asset-backed debt securities, fair value is based on observable inputs of comparable market transactions.

(c) For mortgage funds, fair value represents the principal outstanding which is guaranteed by Canada Mortgage and Housing Corporation.

(d) For venture capital partnership investments, fair value is generally established by using revenue or earnings multiples or other relevant market data including Initial Public Offerings.

(e) For cash balances that are held in Level 2 funds prior to investment in those fund units, the cash value is treated as a Level 2 input.

The change in the fair value of Level 3 assets, which use significant unobservable inputs to measure fair value, is shown in the table below:

| millions of dollars | Mortgage funds | Venture capital |
|---|---|---|
| Fair value at January 1, 2012 | 1 | 148 |
| Net realized gains/(losses) | - | (11) |
| Net unrealized gains/(losses) | - | 8 |
| Net purchases/(sales) | - | 13 |
| Fair value at December 31, 2012 | 1 | 158 |

The 2011 fair value of the pension plan assets, including the level within the fair value hierarchy, is shown in the table below:

| | | Fair value measurements at December 31, 2011, using: | | | | |
|---|---|---|---|---|---|---|
| millions of dollars | Total | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | | Significant unobservable inputs (Level 3) | |
| Asset class | | | | | | |
| Equity securities | | | | | | |
| Canadian | 723 | | 723 | (a) | | |
| Non-Canadian | 1,408 | | 1,408 | (a) | | |
| Debt securities - Canadian | | | | | | |
| Corporate | 487 | | 487 | (b) | | |
| Government | 1,671 | | 1,671 | (b) | | |
| Asset backed | 15 | | 15 | (b) | | |
| Mortgage funds | 1 | | | | 1 | (c) |
| Equities – Venture capital | 148 | | | | 148 | (d) |
| Cash | 8 | 6 | 2 | (e) | | |
| Total plan assets at fair value | 4,461 | 6 | 4,306 | | 149 | |

(a) For company equity securities held in the form of fund units that are redeemable at the measurement date, the unit value is treated as a Level 2 input. The fair value of the securities owned by the funds is based on observable quoted prices on active exchanges, which are Level 1 inputs.
(b) For corporate, government and asset-backed debt securities, fair value is based on observable inputs of comparable market transactions.
(c) For mortgage funds, fair value represents the principal outstanding which is guaranteed by Canada Mortgage and Housing Corporation.
(d) For venture capital partnership investments, fair value is generally established by using revenue or earnings multiples or other relevant market data including Initial Public Offerings.
(e) For cash balances that are held in Level 2 funds prior to investment in those fund units, the cash value is treated as a Level 2 input.

The change in the fair value of Level 3 assets, which use significant unobservable inputs to measure fair value, is shown in the table below:

| millions of dollars | Mortgage funds | Venture capital |
|---|---|---|
| Fair value at January 1, 2011 | 1 | 110 |
| Net realized gains/(losses) | - | (8) |
| Net unrealized gains/(losses) | - | 27 |
| Net purchases/(sales) | - | 19 |
| Fair value at December 31, 2011 | 1 | 148 |

## **Notes to consolidated financial statements** (continued)

A summary of pension plans with accumulated benefit obligations in excess of plan assets is shown in the table below:

| | Pension benefits | |
|---|---|---|
| millions of dollars | **2012** | 2011 |
| For funded pension plans with accumulated benefit obligations in excess of plan assets: | | |
| Projected benefit obligation | **6,716** | 6,056 |
| Accumulated benefit obligation | **6,025** | 5,436 |
| Fair value of plan assets | **5,114** | 4,461 |
| Accumulated benefit obligation less fair value of plan assets | **911** | 975 |
| For unfunded plans covered by book reserves: | | |
| Projected benefit obligation | **620** | 590 |
| Accumulated benefit obligation | **535** | 534 |

### Estimated 2013 amortization from accumulated other comprehensive income

| millions of dollars | Pension benefits | Other post-retirement benefits |
|---|---|---|
| Net actuarial loss/(gain) (a) | 246 | 10 |
| Prior service cost (b) | 23 | - |

(a) The company amortizes the net balance of actuarial loss/(gain) as a component of net periodic benefit cost over the average remaining service period of active plan participants.
(b) The company amortizes prior service cost on a straight-line basis.

### Cash flows

Benefit payments expected in:

| millions of dollars | Pension benefits | Other post-retirement benefits |
|---|---|---|
| 2013 | 335 | 28 |
| 2014 | 345 | 28 |
| 2015 | 356 | 28 |
| 2016 | 366 | 28 |
| 2017 | 376 | 28 |
| 2018 - 2022 | 1,989 | 144 |

In 2013, the company expects to make cash contributions of about $680 million to its pension plans.

### Sensitivities

A one percent change in the assumptions at which retirement liabilities could be effectively settled is as follows:

| Increase/(decrease) millions of dollars | One percent increase | One percent decrease |
|---|---|---|
| Rate of return on plan assets: | | |
| Effect on net benefit cost, before tax | (45) | 45 |
| Discount rate: | | |
| Effect on net benefit cost, before tax | (75) | 95 |
| Effect on benefit obligation | (980) | 1,235 |
| Rate of pay increases: | | |
| Effect on net benefit cost, before tax | 45 | (40) |
| Effect on benefit obligation | 225 | (200) |

A one percent change in the assumed health-care cost trend rate would have the following effects:

| Increase/(decrease)<br>millions of dollars | One percent increase | One percent decrease |
|---|---|---|
| Effect on service and interest cost components | 3 | (3) |
| Effect on benefit obligation | 49 | (40) |

## 5. Other long-term obligations

| millions of dollars | **2012** | 2011 |
|---|---|---|
| Employee retirement benefits (note 4)(a) | **2,717** | 2,645 |
| Asset retirement obligations and other environmental liabilities (b) | **957** | 914 |
| Share-based incentive compensation liabilities (note 7) | **117** | 125 |
| Other obligations | **192** | 192 |
| Total other long-term obligations | **3,983** | 3,876 |

(a) Total recorded employee retirement benefit obligations also include $52 million in current liabilities (2011 – $48 million).
(b) Total asset retirement obligations and other environmental liabilities also include $168 million in current liabilities (2011 – $145 million).

Asset retirement obligations incurred in the current period were Level 3 (unobservable inputs) fair value measurements. The following table summarizes the activity in the liability for asset retirement obligations:

| millions of dollars | **2012** | 2011 |
|---|---|---|
| January 1 balance | **936** | 773 |
| Additions | **61** | 217 |
| Reductions due to property sales | **(8)** | - |
| Accretion | **86** | 46 |
| Settlement | **(109)** | (100) |
| December 31 balance | **966** | 936 |

## 6. Derivatives and financial instruments

The company did not enter into any derivative instruments to offset exposures associated with hydrocarbon prices, foreign currency exchange rates and interest rates that arose from existing assets, liabilities and transactions in the past three years. The company did not engage in speculative derivative activities or derivative trading activities nor did it use derivatives with leveraged features. The company maintains a system of controls that includes a policy covering the authorization, reporting and monitoring of derivative activity.

The fair value of the company's financial instruments is determined by reference to various market data and other appropriate valuation techniques. There are no material differences between the fair values of the company's financial instruments and the recorded book value. The fair value hierarchy for long-term debt is primarily Level 2 (observable input).

## 7. Share-based incentive compensation programs

Share-based incentive compensation programs are designed to retain selected employees, reward them for high performance and promote individual contribution to sustained improvement in the company's future business performance and shareholder value.

**Restricted stock units and deferred share units**

Under the restricted stock unit plan, each unit entitles the recipient to the conditional right to receive from the company, upon exercise, an amount equal to the five-day average of the closing price of the company's common shares on the Toronto Stock Exchange on and immediately prior to the exercise dates. Fifty percent of the units are exercised three years following the grant date, and the remainder is exercised seven years following the grant date. The company may also issue units where 50 percent of the units are exercisable five years following the grant date and the remainder is exercisable on the later of ten years following the grant date or the retirement date of the recipient.

The deferred share unit plan is made available to nonemployee directors. The nonemployee directors can elect to receive all or part of their directors' fees in units. The number of units granted is determined at the end of each calendar quarter by dividing the dollar amount of the nonemployee director's fees for that calendar quarter elected to be received as deferred share units by the average closing price of the company's shares for the five consecutive trading days immediately prior to the last day of the calendar quarter. Additional units are granted based on the cash dividend payable on the company's shares divided by the average closing price immediately prior to the payment date for that dividend and multiplying the resulting number by the number of deferred share units held by the recipient, as adjusted for any share splits. Deferred share units cannot be exercised until after resignation as a director and must be exercised no later than December 31 of the year following resignation. On the exercise date, the cash value to be received for the units is determined based on the average closing price of the company's shares for the five consecutive trading days immediately prior to the date of exercise, as adjusted for any share splits.

All units require settlement by cash payments with the following exceptions. The restricted stock unit program was amended for units granted in 2002 and subsequent years to Canadian residents by providing that the recipient may receive one common share of the company per unit or elect to receive the cash payment for the units to be exercised in the seventh year following the grant date. For units where 50 percent are exercisable five years following the grant date and the remainder exercisable on the later of ten years following the grant date or the retirement date of the recipient, the recipient may receive one common share of the company per unit or elect to receive cash payment for all units to be exercised.

The company accounts for all units by using the fair-value-based method. The fair value of awards in the form of restricted stock and deferred share units is the market price of the company's stock. Under this method, compensation expense related to the units of these programs is measured each reporting period based on the company's current stock price and is recorded in the consolidated statement of income over the requisite service period of each award.

The following table summarizes information about these units for the year ended December 31, 2012:

| | Restricted stock units | Deferred share units |
|---|---|---|
| Outstanding at January 1, 2012 | **9,333,713** | **72,297** |
| Granted | **1,789,950** | **13,208** |
| Exercised | **(2,155,999)** | **-** |
| Forfeited and cancelled | **(24,560)** | **-** |
| Outstanding at December 31, 2012 | **8,943,104** | **85,505** |

The compensation expense charged against income for these programs was $58 million, $91 million and $57 million for the years ended December 31, 2012, 2011 and 2010, respectively. Income tax benefit recognized in income related to compensation expense for the years ended December 31, 2012, 2011 and 2010 was $20 million, $33 million and $27 million, respectively. Cash payments of $97 million, $173 million and $152 million for these programs were made in 2012, 2011 and 2010, respectively.

As of December 31, 2012, there was $204 million of total before-tax unrecognized compensation expense related to non-vested restricted stock units based on the company's share price at the end of the current reporting period. The weighted average vesting period of nonvested restricted stock units is 3.7 years. All units under the deferred share programs have vested as of December 31, 2012.

**Incentive stock options**

In April 2002, incentive stock options were granted for the purchase of the company's common shares. For units exercised subsequent to the company's May 2006 three-for-one split, the company gave the option holders the right to purchase three shares for each original stock option granted. The exercise price was $15.50 per share (adjusted to reflect the three-for-one share split). All options had been exercised as of December 31, 2012. The company has not issued incentive stock options since 2002 and has no plans to issue incentive stock options in the future.

Since incentive stock option awards vested prior to the effective date of current authoritative guidance relating to accounting for stock-based compensation, they were accounted for under the prior prescribed method. Under this method, compensation expense of incentive stock option awards was not recognized, as the exercise price of the option is equal to the market price of the stock on the date of grant.

The company has purchased shares on the market to fully offset the dilutive effects from the exercise of stock options.

The following table summarizes information about stock options for the year ended December 31, 2012:

| | Units | Exercise price (dollars) | Remaining contractual term (years) |
|---|---|---|---|
| Incentive stock options | | | |
| Outstanding at January 1, 2012 | **2,775,708** | **15.50** | **0.3** |
| Granted | **-** | | |
| Exercised | **(2,775,708)** | **15.50** | |
| Forfeited and cancelled | **-** | | |
| Outstanding at December 31, 2012 | **-** | | |

## 8. Investment and other income

Investment and other income includes gains and losses on asset sales as follows:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Proceeds from asset sales | **226** | 314 | 144 |
| Book value of assets sold | **132** | 117 | 49 |
| Gain/(loss) on asset sales, before tax (a) | **94** | 197 | 95 |
| Gain/(loss) on asset sales, after tax (a) | **72** | 153 | 80 |

(a) 2011 included gains of $104 million ($76 million, after tax) from the sale of the company's interests in shallow gas properties in the Medicine Hat, Alberta area, the Coleville-Hoosier natural gas producing property in Saskatchewan and the Rainbow Lake producing property in Alberta. 2011 also included a gain of $55 million ($40 million, after tax) from an exchange of oil sands leases with a third party.

## 9. Litigation and other contingencies

A variety of claims have been made against Imperial Oil Limited and its subsidiaries in a number of lawsuits. Management has regular litigation reviews, including updates from corporate and outside counsel, to assess the need for accounting recognition or disclosure of these contingencies. The company accrues an undiscounted liability for those contingencies where the incurrence of a loss is probable and the amount can be reasonably estimated. If a range of amounts can be reasonably estimated and no amount within the range is a better estimate than any other amount, then the minimum of the range is accrued. The company does not record liabilities when the likelihood that the liability has been incurred is probable but the amount cannot be reasonably estimated or when the liability is believed to be only reasonably possible or remote. For contingencies where an unfavourable outcome is reasonably possible and which are significant, the company discloses the nature of the contingency and, where feasible, an estimate of the possible loss. For purposes of the company's contingency disclosures, "significant" includes material matters as well as other matters which management believes should be disclosed. Based on a consideration of all relevant facts and circumstances, the company does not believe the ultimate outcome of any currently pending lawsuits against the company will have a material adverse effect on the company's operations, financial condition, or financial statements taken as a whole.

Additionally, the company has other commitments arising in the normal course of business for operating and capital needs, all of which are expected to be fulfilled with no adverse consequences material to the company's operations or financial condition. Unconditional purchase obligations, as defined by accounting standards, are those long-term commitments that are non-cancelable or cancelable only under certain conditions and that third parties have used to secure financing for the facilities that will provide the contracted goods and services.

| millions of dollars | Payments due by period 2013 | 2014 | 2015 | 2016 | 2017 | After 2017 | Total |
|---|---|---|---|---|---|---|---|
| Unconditional purchase obligations (a) | **77** | **55** | **54** | **54** | **54** | **176** | **470** |

(a) Undiscounted obligations of $470 million mainly pertain to pipeline throughput agreements. Total payments under unconditional purchase obligations were $86 million (2011 - $73 million, 2010 - $78 million). The present value of these commitments, excluding imputed interest of $97 million, totaled $373 million.

## 10. Common shares

| thousands of shares | **As at Dec. 31 2012** | As at Dec. 31 2011 |
|---|---|---|
| Authorized | **1,100,000** | 1,100,000 |

From 1995 through 2011, the company purchased shares under seventeen 12-month normal course issuer bid share repurchase programs, as well as an auction tender. On June 25, 2012, another 12-month normal course issuer bid program was implemented with an allowable purchase of up to about 42 million shares, including shares purchased from Exxon Mobil Corporation and shares purchased by the employee savings plan and company pension fund. The results of these activities are as shown below.

| Year | Purchased shares (thousands) | Millions of dollars |
|---|---|---|
| 1995 to 2010 | 902,503 | 15,521 |
| 2011 | 1,262 | 59 |
| **2012** | **2,776** | **128** |
| Cumulative purchases to date | 906,541 | 15,708 |

Exxon Mobil Corporation's participation in the above maintained its ownership interest in Imperial at 69.6 percent.

The excess of the purchase cost over the stated value of shares purchased has been recorded as a distribution of earnings reinvested.

The company's common share activities are summarized below:

| | Thousands of shares | Millions of dollars |
|---|---|---|
| Balance as at January 1, 2010 | 847,599 | 1,508 |
| Issued under employee share-based awards | 208 | 3 |
| Purchases at stated value | (208) | - |
| Balance as at December 31, 2010 | 847,599 | 1,511 |
| Issued under employee share-based awards | 1,262 | 19 |
| Purchases at stated value | (1,262) | (2) |
| Balance as at December 31, 2011 | 847,599 | 1,528 |
| **Issued under employee share-based awards** | **2,776** | **43** |
| **Purchases at stated value** | **(2,776)** | **(5)** |
| **Balance as at December 31, 2012** | **847,599** | **1,566** |

The following table provides the calculation of basic and diluted earnings per share:

| | **2012** | 2011 | 2010 |
|---|---|---|---|
| **Net income per common share – basic** | | | |
| Net income (millions of dollars) | **3,766** | 3,371 | 2,210 |
| Weighted average number of common shares outstanding (millions of shares) | **847.7** | 847.7 | 847.6 |
| Net income per common share (dollars) | **4.44** | 3.98 | 2.61 |
| **Net income per common share - diluted** | | | |
| Net income (millions of dollars) | **3,766** | 3,371 | 2,210 |
| Weighted average number of common shares outstanding (millions of shares) | **847.7** | 847.7 | 847.6 |
| Effect of employee share-based awards (millions of shares) | **3.4** | 5.9 | 6.6 |
| Weighted average number of common shares outstanding, assuming dilution (millions of shares) | **851.1** | 853.6 | 854.2 |
| Net income per common share (dollars) | **4.42** | 3.95 | 2.59 |

## 11. Miscellaneous financial information

In 2012, net income included an after-tax gain of $45 million (2011 – $10 million gain, 2010 – $38 million gain) attributable to the effect of changes in last-in, first-out (LIFO) inventories. The replacement cost of inventories was estimated to exceed their LIFO carrying values at December 31, 2012 by $1,769 million (2011 – $2,196 million). Inventories of crude oil and products at year-end consisted of the following:

| millions of dollars | **2012** | 2011 |
|---|---|---|
| Crude oil | **473** | 448 |
| Petroleum products | **284** | 247 |
| Chemical products | **60** | 57 |
| Natural gas and other | **10** | 10 |
| Total inventories of crude oil and products | **827** | 762 |

Net research and development costs charged to expenses in 2012 were $147 million (2011 – $120 million, 2010 – $97 million). These costs are included in expenses due to the uncertainty of future benefits.

Cash flow from operating activities included dividends of $1 million received from equity investments in 2012 (2011 – $3 million, 2010 – $9 million).

Accounts payable and accrued liabilities included accrued taxes other than income taxes of $377 million at December 31, 2012 (2011 - $540 million).

## 12. Financing costs

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Debt-related interest | **20** | 16 | 6 |
| Capitalized interest | **(20)** | (16) | (6) |
| Net interest expense | **-** | - | - |
| Other interest | **(1)** | 3 | 7 |
| Total financing costs (a) | **(1)** | 3 | 7 |

(a) Cash interest payments in 2012 were $20 million (2011 – $16 million, 2010 – $12 million). The weighted average interest rate on short-term borrowings in 2012 was 1.1 percent (2011 – 1.0 percent).

## 13. Leased facilities

At December 31, 2012, the company held non-cancelable operating leases covering office buildings, rail cars, service stations and other properties with minimum undiscounted lease commitments totaling $511 million as indicated in the following table:

| | Payments due by period | | | | | | |
|---|---|---|---|---|---|---|---|
| millions of dollars | 2013 | 2014 | 2015 | 2016 | 2017 | After 2017 | Total |
| Lease payments under minimum commitments (a) | **180** | **144** | **107** | **32** | **23** | **25** | **511** |

(a) Net rental cost under cancelable and non-cancelable operating leases incurred in 2012 was $271 million (2011 – $226 million, 2010 – $173 million). Related rental income was not material.

## 14. Long-term debt

| millions of dollars | **As at Dec. 31 2012** | As at Dec. 31 2011 |
|---|---|---|
| Long-term debt (a) | **1,040** | 820 |
| Capital leases (b) | **135** | 23 |
| Total long-term debt | **1,175** | 843 |

(a) Borrowed under an existing agreement with an affiliated company of Exxon Mobil Corporation (ExxonMobil) that provides for a long-term, variable-rate loan from ExxonMobil to the company of up to $5 billion (Canadian) at interest equivalent to Canadian market rates. The agreement is effective until July 31, 2020, cancelable if ExxonMobil provides at least 370 days advance written notice. Average effective rate for the loan was 1.3 percent in 2012.

(b) Capitalized lease obligations primarily relate to capital leases for pipeline transportation and marine services agreements. The average imputed rate was 9.6 percent in 2012 (2011 – 11.4 percent). Total capitalized lease obligations also include $7 million in current liabilities (2011 - $4 million). Principal payments on capital leases of approximately $7 million a year are due in each of the next four years after December 31, 2013.

In the third quarter of 2012, the company increased the amount of its existing stand-by long-term bank credit facility from $200 million to $300 million and extended the maturity date to August 2014. Subsequent to year-end, in February 2013, this long-term bank credit facility was increased by an additional $200 million to $500 million with the maturity date unchanged. The company has not drawn on the facility.

In February 2013, the company increased its long-term debt by $1.3 billion by drawing on an existing facility with an affiliated company of Exxon Mobil Corporation and increased short-term debt by $0.5 billion by issuing additional commercial paper.  The majority of the increased debt was used to finance the acquisition of a 50-percent interest in Celtic's assets and liabilities.

## 15. Accounting for suspended exploratory well costs

The company continues capitalization of exploratory well costs when the well has found a sufficient quantity of reserves to justify its completion as a producing well and the company is making sufficient progress assessing the reserves and the economic and operating viability of the project. The term “project” as used in this report does not necessarily have the same meaning as under SEC Rule 13q-1 relating to government payment reporting. For example, a single project for purposes of the rule may encompass numerous properties, agreements, investments, developments, phases, work efforts, activities and components, each of which we may also informally describe as a “project”.

The following two tables provide details of the changes in the balance of suspended exploratory well costs as well as an aging summary of those costs.

Change in capitalized suspended exploratory well costs:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| January 1 balance | **163** | 120 | 45 |
| Additions pending the determination of proved reserves | **16** | 43 | 75 |
| Charged to expense | **-** | - | - |
| Reclassification to wells, facilities and equipment based on the determination of proved reserves | **(12)** | - | - |
| December 31 balance | **167** | 163 | 120 |

Period end capitalized suspended exploratory well costs:

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Capitalized for a period of one year or less | **16** | 43 | 75 |
| Capitalized for a period of between one and five years | **151** | 120 | 45 |
| Capitalized for a period of greater than one year | **151** | 120 | 45 |
| Total | **167** | 163 | 120 |

Exploration activity often involves drilling multiple wells, over a number of years, to fully evaluate a project. The table below provides a numerical breakdown of the number of projects with suspended exploratory well costs which had their first capitalized well drilled in the preceding 12 months and those that have had exploratory well costs capitalized for a period greater than 12 months.

| | **2012** | 2011 | 2010 |
|---|---|---|---|
| Number of projects with first capitalized well drilled in the preceding 12 months | **-** | 1 | - |
| Number of projects that have exploratory well costs capitalized for a period of greater than 12 months | **1** | 1 | 1 |
| Total | **1** | 2 | 1 |

The project with exploratory well costs capitalized for a period greater than 12 months as of December 31, 2012 has drilling in the preceding 12 months.

## 16. Transactions with related parties

Revenues and expenses of the company also include the results of transactions with Exxon Mobil Corporation and affiliated companies (ExxonMobil) in the normal course of operations. These were conducted on terms as favourable as they would have been with unrelated parties and primarily consisted of the purchase and sale of crude oil, petroleum and chemical products, as well as technical, engineering and research and development costs. Transactions with ExxonMobil also included amounts paid and received in connection with the company's participation in a number of upstream activities conducted jointly in Canada.

In addition, the company has existing agreements with ExxonMobil to:

a) provide computer and customer support services to the company and to share common business and operational support services that allow the companies to consolidate duplicate work and systems;

b) operate certain Western Canada production properties owned by ExxonMobil as well as provide for the delivery of management, business and technical services to ExxonMobil in Canada. These agreements are designed to provide organizational efficiencies and to reduce costs. No separate legal entities were created from these arrangements. Separate books of account continue to be maintained for the company and ExxonMobil. The company and ExxonMobil retain ownership of their respective assets, and there is no impact on operations or reserves;

c) provide for the delivery of management, business and technical services to Syncrude Canada Ltd. by ExxonMobil; and

d) provide for the option of equal participation in new upstream opportunities.

Certain charges from ExxonMobil have been capitalized; they are not material in the aggregate.

As at December 31, 2012, the company had outstanding loans of $1,040 million (2011 – $820 million) from ExxonMobil (see note 14, long-term debt, on page A47 for further details).

As at December 31, 2012, the company had outstanding loans of $4 million (2011 - $18 million) to Montreal Pipe Line Limited, in which the company has an equity interest, for financing of the equity company's capital expenditure programs and working capital requirements.

## 17. Subsequent event

**Description of the Transaction:** On February 26, 2013, ExxonMobil Canada acquired Celtic Exploration Ltd. (“Celtic”). Immediately following the acquisition, Imperial acquired a 50-percent interest in Celtic’s assets and liabilities from ExxonMobil Canada for $1.6 billion, financed by a combination of related party and third party debt (see note 14 for further details). Concurrently, a general partnership was formed to hold and operate the assets of Celtic. Celtic is involved in the exploration for, production of, and transportation and sale of natural gas and crude oil, condensate and natural gas liquids.

**Recording of Assets Acquired and Liabilities Assumed:** Imperial used the acquisition method of accounting to record its pro-rata share of the assets acquired and liabilities assumed. This method requires, among other things, that assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. Due to the proximity of the acquisition date to the 2012 Form 10-K filing date, the fair values of the assets acquired and liabilities assumed could not be finalized by the filing date. They will be disclosed in the company’s first quarter 2013 Form 10-Q.

**Pro Forma Impact of the Acquisition:** Unaudited pro forma revenues, earnings and basic and diluted earnings per share information as if the acquisition had occurred at the beginning of 2012 is not presented, since the effect on Imperial’s consolidated 2012 financial results would not have been material.

# Supplemental information on oil and gas exploration and production activities (unaudited)

The information on pages A51 to A52 excludes items not related to oil and natural gas extraction, such as administrative and general expenses, pipeline operations, gas plant processing fees and gains or losses on asset sales. The company's 25 percent interest in proved synthetic oil reserves in the Syncrude joint-venture and 70.96 percent interest in proved bitumen reserves in the Kearl project are included as part of the company's total proved oil and gas reserves in accordance with U.S. Securities and Exchange Commission (SEC) and U.S. Financial Accounting Standards Board (FASB) rules. Similarly, the company's share of proved synthetic oil reserves from Syncrude and proved bitumen reserves from Kearl are included in the calculation of the standardized measure of discounted future cash flows. Results of operations, costs incurred in property acquisitions, exploration and development activities, and capitalized costs include the company's share of Syncrude, Kearl and other unproved mineable acreages in the following tables.

**Results of operations**

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Sales to customers (a) | **2,074** | 2,185 | 2,094 |
| Intersegment sales (a)(b) | **3,534** | 3,828 | 3,165 |
| | **5,608** | 6,013 | 5,259 |
| Production expenses | **2,589** | 2,352 | 2,225 |
| Exploration expenses | **83** | 90 | 190 |
| Depreciation and depletion | **498** | 530 | 521 |
| Income taxes | **584** | 718 | 591 |
| Results of operations | **1,854** | 2,323 | 1,732 |

**Costs incurred in property acquisitions, exploration and development activities**

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Property costs (c) | | | |
| Proved | **-** | - | - |
| Unproved | **33** | 114 | 70 |
| Exploration costs | **109** | 133 | 260 |
| Development costs | **5,125** | 3,792 | 3,515 |
| Total costs incurred in property acquisitions, exploration and development activities | **5,267** | 4,039 | 3,845 |

The amounts reported as costs incurred in property acquisitions, exploration and development activities include both capitalized costs and costs charged to expense during the year. Costs incurred also include new asset retirement obligations established in the current year, as well as increases or decreases to the asset retirement obligation resulting from changes in cost estimates or abandonment.

**Capitalized costs**

| millions of dollars | **2012** | 2011 |
|---|---|---|
| Property costs (c) | | |
| Proved | **2,974** | 2,984 |
| Unproved | **616** | 636 |
| Producing assets | **13,322** | 12,735 |
| Incomplete construction | **13,062** | 8,876 |
| Total capitalized cost | **29,974** | 25,231 |
| Accumulated depreciation and depletion | **(10,140)** | (9,740) |
| Net capitalized costs | **19,834** | 15,491 |

(a) Sales to customers or intersegment sales do not include the sale of natural gas and natural gas liquids purchased for resale, as well as royalty payments. These items are reported gross in note 2 in "operating revenues", "intersegment sales" and in "purchases of crude oil and products".

(b) Sales of crude oil to consolidated affiliates are at market value, using posted field prices. Sales of natural gas liquids to consolidated affiliates are at prices estimated to be obtainable in a competitive, arm's-length transaction.

(c) "Property costs" are payments for rights to explore for petroleum and natural gas and for purchased reserves (acquired tangible and intangible assets such as gas plants, production facilities and producing-well costs are included under "producing assets"). "Proved" represents areas where successful drilling has delineated a field capable of production. "Unproved" represents all other areas.

## Supplemental information on oil and gas exploration and production activities
(unaudited) (continued)

### Standardized measure of discounted future cash flows

As required by the U.S. Financial Accounting Standards Board (FASB), the standardized measure of discounted future net cash flows is computed by applying first-day-of-the-month average prices, year-end costs and legislated tax rates and a discount factor of 10 percent to net proved reserves. The standardized measure includes costs for future dismantlement, abandonment and remediation obligations. The company believes the standardized measure does not provide a reliable estimate of the company's expected future cash flows to be obtained from the development and production of its oil and gas properties or of the value of its proved oil and gas reserves. The standardized measure is prepared on the basis of certain prescribed assumptions, including first-day-of-the-month average prices, which represent discrete points in time and therefore may cause significant variability in cash flows from year to year as prices change.

### Standardized measure of discounted future net cash flows related to proved oil and gas reserves

| millions of dollars | **2012** | 2011 | 2010 |
|---|---|---|---|
| Future cash flows | **227,253** | 224,130 | 158,835 |
| Future production costs | **(83,600)** | (82,903) | (62,051) |
| Future development costs | **(31,051)** | (27,259) | (16,920) |
| Future income taxes | **(25,902)** | (26,671) | (18,765) |
| Future net cash flows | **86,700** | 87,297 | 61,099 |
| Annual discount of 10 percent for estimated timing of cash flows | **(61,864)** | (61,277) | (39,848) |
| Discounted future cash flows | **24,836** | 26,020 | 21,251 |

### Changes in standardized measure of discounted future net cash flows related to proved oil and gas reserves

| | | | |
|---|---|---|---|
| Balance at beginning of year | **26,020** | 21,251 | 13,375 |
| Changes resulting from: | | | |
| Sales and transfers of oil and gas produced, net of production costs | **(3,116)** | (3,764) | (3,130) |
| Net changes in prices, development costs and production costs | **(6,810)** | 2,845 | 4,217 |
| Extensions, discoveries, additions and improved recovery, less related costs | **2,698** | 1,694 | (2) |
| Development costs incurred during the year | **5,086** | 3,583 | 3,360 |
| Revisions of previous quantity estimates | **(805)** | 165 | 4,085 |
| Accretion of discount | **997** | 1,725 | 998 |
| Net change in income taxes | **766** | (1,479) | (1,652) |
| Net change | **(1,184)** | 4,769 | 7,876 |
| Balance at end of year | **24,836** | 26,020 | 21,251 |

## Supplemental information on oil and gas exploration and production activities (unaudited) (continued)

**Net Proved Reserves** (a)

| | Liquids (b) | Natural gas | Synthetic oil | Bitumen | Total oil-equivalent basis (c) |
|---|---|---|---|---|---|
| | millions of barrels | billions of cubic feet | millions of barrels | millions of barrels | millions of barrels |
| Beginning of year 2010 | 63 | 590 | 691 | 1,661 | 2,513 |
| Revisions | 2 | 80 | 14 | 96 | 125 |
| Improved recovery | - | - | - | - | - |
| (Sale)/purchase of reserves in place | - | (2) | - | - | - |
| Discoveries and extensions | - | 1 | - | - | - |
| Production | (8) | (93) | (24) | (42) | (89) |
| End of year 2010 | 57 | 576 | 681 | 1,715 | 2,549 |
| Revisions | 4 | 11 | (4) | 36 | 38 |
| Improved recovery | - | - | - | - | - |
| (Sale)/purchase of reserves in place | - | (103) | - | - | (17) |
| Discoveries and extensions | - | 21 | - | 706 | 709 |
| Production | (6) | (83) | (24) | (44) | (88) |
| End of year 2011 | 55 | 422 | 653 | 2,413 | 3,191 |
| **Revisions** | **5** | **98** | **(29)** | **239** | **231** |
| **Improved recovery** | **-** | **-** | **-** | **-** | **-** |
| **(Sale)/purchase of reserves in place** | **-** | **(7)** | **-** | **-** | **(1)** |
| **Discoveries and extensions** | **-** | **47** | **-** | **234** | **242** |
| **Production** | **(7)** | **(72)** | **(25)** | **(45)** | **(89)** |
| **End of year 2012** | **53** | **488** | **599** | **2,841** | **3,574** |
| **Net Proved Developed Reserves included above, as of** | | | | | |
| January 1, 2010 | 62 | 526 | 691 | 468 | 1,309 |
| December 31, 2010 | 56 | 507 | 681 | 519 | 1,340 |
| December 31, 2011 | 55 | 360 | 653 | 519 | 1,287 |
| **December 31, 2012** | **52** | **373** | **599** | **543** | **1,256** |
| **Net Proved Undeveloped Reserves included above, as of** | | | | | |
| January 1, 2010 | 1 | 64 | - | 1,193 | 1,204 |
| December 31, 2010 | 1 | 69 | - | 1,196 | 1,209 |
| December 31, 2011 | - | 62 | - | 1,894 | 1,904 |
| **December 31, 2012** | **1** | **115** | **-** | **2,298** | **2,318** |

(a) Net reserves are the company's share of reserves after deducting the shares of mineral owners or governments or both. All reported reserves are located in Canada. Reserves of natural gas are calculated at a pressure of 14.73 pounds per square inch at 60°F.

(b) Liquids include crude, condensate and natural gas liquids (NGLs). NGL proved reserves are not material and are therefore included under liquids.

(c) Gas converted to oil-equivalent at 6 million cubic feet per one thousand barrels.

The information above describes changes during the years and balances of proved oil and gas reserves at year-end 2010, 2011 and 2012. The definitions used are in accordance with the U.S. Securities and Exchange Commission's (SEC) Rule 4-10 (a) of Regulation S-X.

Proved oil and gas reserves are those quantities of oil and gas, which, by analysis of geoscience and engineering data, can be estimated with reasonable certainty to be economically producible – from a given date forward, from known reservoirs, and under existing economic conditions, operating methods and government regulations – prior to the time at which contracts providing the right to operate expire. In some cases, substantial new investments in additional wells and other facilities will be required to recover these proved reserves.

In accordance with SEC rules, the year-end reserves volumes as well as the reserves change categories shown in the proved reserves tables were calculated using average prices during the 12-month period prior to the ending date of the period covered by the report, determined as an unweighted arithmetic average of the first-day-of-the-month price for each month within such period. These reserves quantities were also used in calculating unit-of-production depreciation rates and in calculating the standardized measure of discounted net cash flow.

Revisions can include upward or downward changes in previously estimated volumes of proved reserves for existing fields due to the evaluation or revaluation of already available geologic, reservoir or production data; new geologic, reservoir or production data; or changes in prices and costs that are used in the determination of reserves. This category can also include significant changes in either development strategy or production equipment/facility capacity.

In 2012, the quantities shown in the discoveries and extensions category under proved reserves were due to the initial booking of the approved Nabiye expansion project at Cold Lake. Upward revisions of proved bitumen and natural gas reserves were primarily a result of increased development scope at Cold Lake. Bitumen revisions also include the impact of royalty costs at Kearl.

Net proved reserves are determined by deducting the estimated future share of mineral owners or governments or both. For liquids and natural gas, net proved reserves are based on estimated future royalty rates as of the date the estimate is made incorporating the applicable governments' oil and gas royalty regimes. For bitumen, net proved reserves are based on the company's best estimate of average royalty rates over the life of each of the Cold Lake and Kearl projects, and they incorporate the Alberta government's revised oil sands royalty regime. For synthetic oil, net proved reserves are based on the company's best estimate of average royalty rates over the life of the project, and they incorporate amendments to the Syncrude Crown Agreement. In all cases, actual future royalty rates may vary with production, price and costs.

Net proved developed reserves are those volumes that are expected to be recovered through existing wells and facilities with existing equipment and operating methods or in which the cost of the required equipment is relatively minor compared to the cost of a new well or facility. Net proved undeveloped reserves are those volumes that are expected to be recovered as a result of future investments to drill new wells, to recomplete existing wells and/or to install facilities to collect and deliver the production from existing and future wells and facilities.

No independent qualified reserves evaluator or auditor was involved in the preparation of the reserves data.

# Quarterly financial and stock trading data (a)

| | 2012 three months ended | | | | 2011 three months ended | | | |
|---|---|---|---|---|---|---|---|---|
| | **Mar. 31** | **June 30** | **Sept. 30** | **Dec. 31** | Mar. 31 | June 30 | Sept. 30 | Dec. 31 |
| **Financial data** (millions of dollars) | | | | | | | | |
| Total revenues and other income | **7,533** | **7,515** | **8,336** | **7,804** | 6,871 | 7,774 | 7,945 | 8,124 |
| Total expenses | **6,181** | **6,675** | **6,949** | **6,390** | 5,820 | 6,815 | 6,813 | 6,860 |
| Income before income taxes | **1,352** | **840** | **1,387** | **1,414** | 1,051 | 959 | 1,132 | 1,264 |
| Income taxes | **337** | **205** | **347** | **338** | 270 | 233 | 273 | 259 |
| Net income | **1,015** | **635** | **1,040** | **1,076** | 781 | 726 | 859 | 1,005 |
| **Segmented net income** (millions of dollars) | | | | | | | | |
| Upstream | **542** | **360** | **498** | **488** | 528 | 624 | 534 | 771 |
| Downstream | **455** | **232** | **536** | **549** | 276 | 64 | 272 | 272 |
| Chemical | **35** | **49** | **37** | **44** | 38 | 36 | 37 | 11 |
| Corporate and other | **(17)** | **(6)** | **(31)** | **(5)** | (61) | 2 | 16 | (49) |
| Net income | **1,015** | **635** | **1,040** | **1,076** | 781 | 726 | 859 | 1,005 |
| **Per-share information** (dollars) | | | | | | | | |
| Net earnings – basic | **1.20** | **0.75** | **1.22** | **1.27** | 0.92 | 0.86 | 1.01 | 1.19 |
| Net earnings – diluted | **1.19** | **0.75** | **1.22** | **1.26** | 0.91 | 0.85 | 1.01 | 1.18 |
| Dividends (declared quarterly) | **0.12** | **0.12** | **0.12** | **0.12** | 0.11 | 0.11 | 0.11 | 0.11 |
| **Share prices** (dollars) (b) | | | | | | | | |
| Toronto Stock Exchange | | | | | | | | |
| High | **49.26** | **46.68** | **48.32** | **46.25** | 54.00 | 52.67 | 46.23 | 45.52 |
| Low | **43.72** | **39.77** | **41.43** | **41.44** | 39.06 | 42.79 | 35.56 | 34.15 |
| Close | **45.32** | **42.59** | **45.25** | **42.73** | 49.54 | 44.92 | 37.64 | 45.39 |
| NYSE MKT (U.S. dollars) (b) | | | | | | | | |
| High | **49.32** | **47.36** | **50.00** | **47.02** | 55.63 | 55.00 | 48.09 | 44.73 |
| Low | **43.72** | **38.16** | **40.50** | **42.06** | 39.32 | 43.49 | 34.51 | 32.18 |
| Close | **45.39** | **41.72** | **46.03** | **43.00** | 51.07 | 46.59 | 36.11 | 44.48 |
| **Shares traded** (thousands) (c) | **64,643** | **66,394** | **52,065** | **44,615** | 86,357 | 76,970 | 79,786 | 74,744 |

(a) Quarterly data has not been audited by the company's independent auditors.

(b) Imperial's shares are listed on the Toronto Stock Exchange. The company's shares also trade in the United States of America on the NYSE MKT LLC. Imperial has unlisted privileges on the NYSE MKT LLC, a subsidiary of NYSE Euronext. The symbol on these exchanges for Imperial's common shares is IMO. Share prices were obtained from stock exchange records. U.S. dollar share price presented is based on consolidated U.S. market data.

(c) The number of shares traded is based on transactions on the above stock exchanges.