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Update on the International Accounting Standards Board extractive activities research project and financial reporting

Note by the secretariat

1. The minerals and oil and gas industries are an important part of the international capital markets. However, these industries have suffered from a lack of comprehensive financial reporting guidance. This has led to significant divergence in financial reporting for extractive activities under International Financial Reporting Standards (IFRS). This is one of the main reasons the International Accounting Standards Board (IASB) has undertaken a research project on a possible future IFRS for extractive industries. Divergence exists, for example, in the following areas: (a) the extent to which the costs of finding, acquiring and developing minerals and oil and gas reserves and resources should be capitalized; (b) the methods of depreciating or amortizing capitalized costs; (c) the degree to which quantities and values of minerals and oil and gas reserves and resources, rather than costs, should affect recognition, measurement and disclosure; and (d) the definition and measurement of minerals and oil and gas reserves and resources.

2. In 2004, the IASB set up an international project team comprising staff from the national standard-setters in Australia, Canada, Norway and South Africa to undertake a detailed assessment of the accounting for extractive activities. The project team's findings and recommendations were presented in the staff Discussion Paper - Extractive Activities, which was published in April 2010, prior to the IASB making any decisions on the standard. Preparers, users and regulators were subsequently invited to comment on the Discussion Paper and submit their responses to the extractive activities project team.

3. This update provides a high-level overview of the responses to the Discussion Paper, focusing on key themes, trends and issues raised.

I. Background

4. The IASB received over 140 responses to the Discussion Paper, which can be viewed on the IASB's website.[1] The respondents were predominately from the minerals and oil and gas majors, accountancy bodies, regulators and accountancy firms, as well as a number of other bodies interested in one or more of the specific provisions. There appears to have been little response from the small- and medium-sized extractive industry companies.

5. A relatively common question from respondents was whether there was a need for a separate standard for the extractive industries. In addition to this, some of the other more significant concerns, discussed in greater detail below, included:

(a) The proposed asset recognition and measurement model;

(b) Potentially burdensome disclosure requirements, which include fair value and sensitivity analyses for reserve and resource volumes; and

(c) The inclusion of Publish What You Pay disclosure requirements within the financial statements.

II. Scope

(a) The need for a separate standard

6. A significant number of responses from the minerals and oil and gas majors, and many from accounting firms and regulators, initially challenged whether sufficient evidence had been provided to justify the need for a separate recognition and measurement standard for extractive activities, particularly as pharmaceuticals and software development industries possess similar technical complexities during the pre-development stage. The IASB was asked to clarify, using a principles-based framework, why such similarities would justify a separate standard.

7. Instead of a separate standard, these respondents suggested that a preferable approach would be to use the current IFRS framework and standards for recognition and measurement. They further suggested that industry implementation and/or application guidance should be provided to address industry specific issues. However, there did appear to be general acceptance that there is a need for a separate extractive activities disclosure standard.

8. There were, however some respondents who did believe that a separate standard would actually be appropriate given that generally accepted practices of the sectors may vary significantly from analogous treatments.

(b) Upstream focus

9. On the basis that a separate standard could be justified, most respondents agreed that targeting this standard at upstream operations was appropriate. However, given the integrated nature of many companies, it was highlighted that any such standard should clearly define the scope and boundaries of such upstream activity.

(c) Key issues not addressed

10. Whilst it has been generally acknowledged that the issues addressed in the Discussion Paper are important, a significant number of respondents commented that the current scope did not address many of the more complex accounting issues where practice is diverse and greater consistency is required.

[1] www.iasb.org

11. These issues include:

(i) The lack of guidance on complex areas such as farm out/in transactions;

(ii) Accounting for production sharing and royalty agreements;

(iii) The relationship between the proposals and IFRS 6 *Exploration for and Evaluation of Minerals Resources*; and

(iv) The omission of regenerative activities.

III. The proposed model

(a) Recognition

12. The asset recognition model in the Discussion Paper proposes that legal rights, such as exploration rights or extraction rights should form the basis for recognition of a minerals or oil and gas asset. Information obtained from subsequent exploration and evaluation activities and development work undertaken to access the minerals or oil and gas deposits would each be treated as enhancements of the legal rights and would, therefore, be capitalized. The responses noted that this recognition model could potentially lead to the capitalization of costs that may not have future economic benefits, such as certain geological and geophysical and other early-stage exploration expenditure. Also, some information may actually detract from the value of the legal right, such as unsuccessful exploration activities like the drilling of dry wells.

13. Minerals and oil and gas respondents, along with a number of accounting firms and regulators, highlighted the inconsistency of this model with the current capitalization principles in the existing IFRS. Most notably, the requirement that probable future economic benefits should exist before expenditure is recognized as an asset does not appear to be part of the Discussion Paper's proposed model.

14. While the minerals and oil and gas majors agreed that the Discussion Paper recognition model was conceptually flawed, the two industries have differing views of what a more appropriate model should look like.

15. The preferred approach of large oil and gas companies appears to be the successful efforts method, currently adopted by a large proportion of majors in the industry. Under this method, the significant exploration and appraisal costs are capitalized as an intangible asset pending declaration of a "commercial" discovery. The Discussion Paper proposal is more aligned to the full cost method of oil and gas accounting permitted under United States Generally Accepted Accounting Principles (US GAAP), and is more often applied by oil and gas independents and small- to medium-sized companies that focus on exploration projects.

16. In contrast, major minerals companies typically incurred expense costs early in the project lifecycle. Therefore, their responses reflect their considerable discomfort with the concept of capitalization of any expenditure before there is a clear expectation that future economic benefits will be realized from such expenditure. Indeed, several large minerals respondents provided examples of the extent of technical and commercial feasibility that would be required to be demonstrated before they would recognize an asset.

(b) Unit of account

17. Respondents expressed concern over the unit of account concept proposed in the Discussion Paper. The Paper recommended that the geographical boundary of the unit of account would be defined initially on the basis of the exploration rights held. As exploration, evaluation and development activities occur, the unit of account would contract progressively until it became no greater than a single area, or group of contiguous areas, for which the legal rights are held, which are managed separately and would be expected to generate largely independent cash

flows. Minerals and oil and gas majors alike believe the concept of a reducing unit of account would be complex to apply in practice and would require significant levels of judgment. Also, in some instances the unit of account may actually increase. Given this, most respondents felt that further guidance was needed on how the unit of account proposal would apply in practice, and how it links to impairment considerations.

(c) Measurement basis

18. While the project team recommended historical cost as the measurement basis, albeit based on a ‘least harm’ conclusion, they acknowledged there was no substantive support for either. Therefore, they requested feedback on which measurement basis should be used, including feedback on both historical cost and current value and even other measurement bases not considered in the Discussion Paper, where appropriate. An overwhelming majority of respondents to this question indicated their strong support for the historical cost approach. This appears to be one of the few areas where both minerals and oil and gas respondents are broadly in agreement with the proposals set forth in the Paper.

IV. Disclosure

19. The Discussion Paper also recommends several new quite significant disclosure requirements, including: (a) disclosure of proved and probable reserve volumes, including the main assumptions used in estimating reserve quantities; (b) a sensitivity analysis; and (c) a current value measurement that corresponds to reserve quantities, with a reconciliation of changes in the current value measure from year to year.

20. The Discussion Paper also proposes that the mineral reserve and resource definitions established by the Committee for Mineral Reserves International Reporting Standards (CRIRSCO) and the oil and gas reserve and resource definitions established by the Society of Petroleum Engineers (SPE) should be adopted for IFRS reporting. Respondents expressed a number of significant concerns related to these proposals, which are discussed further below.

(a) Reserves

21. While the disclosure of reserves quantities was supported by most, the large oil and gas respondents believed disclosure of probable reserve balances should be optional, not mandatory. The heightened risk and uncertainty associated with probable quantities could lead to heightened litigation risk and would significantly increase compliance costs.

22. Respondents expressed concern that adopting the CRIRSCO and SPE definitions would effectively place reliance on an unregulated third party. Further guidance would be required to clarify how any changes to the definition of reserves and resources by CRIRSCO or SPE would be incorporated in a future IFRS. There was also a view that the IASB would have to put in place some form of governance framework to ensure that such definitions continued to be appropriate for financial reporting purposes. Both CRIRSCO and SPE committed themselves, via their responses, to ongoing maintenance and development (as required) of these definitions and their willingness to work with the IASB to minimise divergence between these definitions and other national reporting codes and standards.

(b) Commercial sensitivity

23. In addition to the logistical and process challenges associated with collating data and the new disclosure requirements, many large minerals respondents expressed concern with the disclosure of key assumptions associated with reserves estimates. While the inclusion of qualitative disclosures regarding reserves measurement was supported, and in fact is already disclosed by many entities, the provision of quantitative disclosures, such as pricing and other assumptions, was not. The disclosure of such information could lead to a loss in competitive

advantage and seriously prejudice the position of an entity, for example in mergers and acquisitions transactions and in certain price negotiations which occur with individual customers, e.g., diamonds and industrial minerals.

(c) Sensitivity analysis and fair value disclosures

24. Respondents from both industries commented that the inputs into reserve and resource calculations were non-linear, and simply applying sensitivity to one input without re-basing the whole reserves model would produce a result with little meaning or value. Additionally, the complexities and level of judgment involved in producing a value-based asset disclosure would significantly reduce the reliability a user could place on it. It would appear any cost saving created by applying a historical cost measurement basis would be lost through the requirement for such disclosures. Therefore, this would, in effect, mean adopting one of the ‘harms’ of the fair value measurement basis.

25. A broader question was raised as to how the IASB could justify fair value disclosures being required only by those entities undertaking extractive activities and not more broadly by other industries. Property, plant and equipment and non-current assets are commonly measured at historical cost across many industries, yet there is currently no similar proposal for related outputs to also be disclosed at fair value. Respondents cannot see a fundamental difference that would sufficiently justify these fair value disclosure requirements.

(d) US GAAP convergence

26. A number of the proposed disclosures differ from US GAAP. These include disclosures of:

(i) Key reserve estimate assumptions and sensitivity analysis (not required by US GAAP); and

(ii) Proved and probable reserves (US GAAP only requires proved reserves).

27. There was broad consensus among the respondents on the need for the IASB to work jointly with the United States Financial Accounting Standards Board (FASB), and the various international securities exchange commissions, to produce a single global framework to avoid discrepancies and duplication across reporting jurisdictions. Oil and gas respondents listed in the United States also urged the IASB to allow sufficient time to gauge users’ reactions to the FASB rule changes for reserve estimation and disclosure that only took effect in 2009, before any changes are made to IFRS. Minerals companies commented that United States oil and gas filers are used to the more prescriptive and detailed nature of the FASB and United States Securities and Exchange Commission (SEC) guidelines. In light of this, they felt the IASB needed to ensure that they consult with a broad range of companies impacted to determine the most appropriate level of disclosures rather than simply defaulting to the most detailed level of disclosures currently provided as a benchmark.

(e) Publish What You Pay (PWYP)

28. The PWYP disclosures proposed would require companies to disclose, within the financial statements, all payments made to governmental bodies. This proposal was put forward by a coalition of non-governmental organizations (NGOs). Not surprisingly, NGO respondents supported these disclosure requirements.

29. While non-NGO respondents demonstrated their understanding of the positive intent of such requirements, and may provide such information currently under the Extractive Industries Transparency Initiative (EITI), they did question how this would fit within the IASB’s framework.

30. Putting aside the question of location, broader matters that still need to be addressed were highlighted, including:

(i) The definition and scope of governmental payments;

(ii) How the concept of materiality would be applied given the prescriptive PWYP requirement; and

(iii) The value and need for companies to provide such data for countries not signed up to EITI.

31. Many respondents also believe that significant effort will be required to audit this information, particularly if this information will also be required at a subsidiary level.

V. Next steps

32. There are many complex areas of accounting currently facing extractive industry participants which are not addressed by the current proposals in the Discussion Paper.

33. The various stakeholders have a number of significant concerns over the majority of the proposals. In addition, the minerals and oil and gas majors have differing views about the best way forward.

34. Of particular concern is the poor response rate to the Discussion Paper from small and medium-sized extractive industry participants. These companies will undoubtedly face significant challenges in complying with the proposals in the Paper, which may have a substantial impact on their current business models.

35. The IASB will consider the analysis and proposals contained in the Discussion Paper, together with the comments received, in determining whether to add a project to its active agenda. This is likely to occur in the first half of 2011. This agenda decision will follow the IASB's public consultation on the composition of its technical agenda beyond June 2011.

36. The secretariat would like to thank Ernst & Young LLP for the assistance provided in the preparation of this briefing note.

37. Additional details on the findings and recommendations included in the Discussion Paper are available on the IASB website, under IASB projects.[2]

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[2] http://www.iasb.org/current+projects/IASB+projects/extractive+activities/summary.htm