



IASB Discussion Paper on Extractive Activities- the responses

UNECE Expert on Resource Classification, Second Session,
Geneva, 7 April 2011

Daniel Trotman
Director, Ernst & Young

 **ERNST & YOUNG**
Quality In Everything We Do

Agenda

- ▶ Scope and approach
- ▶ Reserves and resources definitions
- ▶ Asset recognition
- ▶ Unit of account
- ▶ Asset measurement
- ▶ Disclosures

Discussion Paper- introduction

- ▶ Current lack of comprehensive financial reporting guidance for the extractive industries under IFRS
- ▶ Variation in industry practice
 - ▶ Variety of practice under IFRS
 - ▶ Jurisdiction specific reporting requirements
- ▶ *Discussion Paper – Extractive Industries* issued in April 2010
 - ▶ Findings from international project team established by IASB
 - ▶ Invitation for comment
- ▶ Over 140 responses received
 - ▶ Minerals and oil and gas majors, accountancy bodies, regulators accountancy firms
 - ▶ More limited responses from small and medium sized extractive industry participants
 - ▶ Variety of views from respondents

Scope and approach

▶ Proposal

- ▶ The scope of an extractive activities IFRS should include only upstream activities for minerals, oil, and natural gas
- ▶ There should be a single accounting and disclosure model that applies to extractive activities in both the minerals and oil & gas industries

Scope- observations from responses

- ▶ Need for a separate standard?
 - ▶ Some challenge around the need for a separate recognition and measurement standard
 - ▶ Implementation/ application guidance of existing IFRS an alternative?
 - ▶ Also some support
 - ▶ Some general acknowledgement of a need for a separate disclosure standard
 - ▶ Degree of similarity between oil and gas and minerals?
- ▶ Upstream focus
 - ▶ Broad agreement that if new IFRS is justified, the scope should be specific to upstream activities
- ▶ Some key issues not addressed
 - ▶ Narrower scope than IFRS 6- other non-regenerative resources and activities?
 - ▶ Current scope does not address many complex accounting areas such as:
 - ▶ Farm in/ out transactions
 - ▶ Accounting for production sharing and royalty arrangements

Reserves and resources- definitions

- ▶ Proposal
 - ▶ Use of
 - ▶ mineral reserve and resource definitions established by the Committee for Mineral Reserves International Reporting Standards and
 - ▶ the oil & gas reserve and resource definitions established by the Society of Petroleum Engineers (in conjunction with other industry bodies)

- ▶ Adopting definitions of CRIRSCO template and PRMS definitions
 - ▶ Effective reliance on unregulated 3rd parties
- ▶ Clarification required as to how changes in reserves and resources definitions would be incorporated into a future IFRS
- ▶ IASB governance framework required?
 - ▶ Ensure definitions remain appropriate for financial reporting
- ▶ Reporting bodies that require different definitions

Asset recognition

- ▶ Proposal
 - ▶ Legal rights (such as exploration rights and extraction rights) should form the basis of the minerals or oil & gas asset.
 - ▶ The asset is recognised when the legal rights are acquired.
 - ▶ Information obtained from subsequent exploration and evaluation activities and development works undertaken to access the minerals or oil & gas deposit would both be treated as enhancements of the legal rights

Asset recognition- observations from responses

- ▶ Potential increase in capitalised costs
 - ▶ Capitalisation of costs that may not have future economic benefits?
 - ▶ Inconsistent with current IFRS capitalisation principles- probable future economic benefits
 - ▶ Certain information may detract from the value of the legal right?
- ▶ Differing views of an appropriate model- largely reflect industry practice
 - ▶ Oil & Gas companies
 - ▶ Preferred approach appears to be successful efforts
 - ▶ DP proposal more aligned to the full cost method?
 - ▶ Mining
 - ▶ Typically expense costs early in the project lifecycle
 - ▶ Discomfort with capitalising costs prior to a clear expectation of economic benefit - move away from expensing costs early in the project lifecycle
- ▶ Companies with an exploration focus may prefer the proposed model
- ▶ BUT- response rate from smaller industry participants low

Unit of account

▶ Proposal

- ▶ ...the unit of account would initially be defined according to the exploration rights held.
- ▶ As exploration, evaluation and development activities take place, the size of the unit of account would contract
- ▶ By the time of development and production the geographical dimension of the unit of account would be no greater than a single area, or group of contiguous areas, for which the rights are held, which is managed separately and would be expected to generate largely independent cash flows.

Unit of account- observations from responses

- ▶ Uncertainty amongst respondents on application of proposal in practice
 - ▶ Complex to apply in practice
 - ▶ Significant judgment required
- ▶ Geographical area does not always contract, ie, acquisition of adjacent leasehold rights
- ▶ Respondents seek further guidance on practical application for matters such as price/cost allocation
- ▶ Likely comparison to predecessor GAAP
- ▶ Interpretative area that gives rise to significant variations in current practice

Asset measurement

- ▶ Proposal
 - ▶ Measurement basis
 - ▶ Measurement at historical cost based on doing 'least harm'
 - ▶ Impairment
 - ▶ An exploration property should be written down to its recoverable amount only when management has enough information to make the determination.
 - ▶ Accordingly, written down when there is a high likelihood that the carrying value is not recoverable in full
 - ▶ Separate set of impairment indicators for exploration properties.

Asset measurement- observations from responses

- ▶ **Historic cost basis**
 - ▶ Majority of respondents agreed that historical cost is the preferred measurement basis
 - ▶ More compelling reasons that just resulting in the “least harm”.
 - ▶ Historical cost is easily measurable and universally understood amongst financial statement users.
 - ▶ Allows users to assess how effectively companies use capital resources (ie, return on capital employed)
 - ▶ Current and fair value require significant judgments and assumptions, making this difficult, costly, and less comparable across companies
 - ▶ Users may not welcome/understand significant balance sheet (and consequent P&L) movements resulting from fair value measurement
- ▶ **Impairment**
 - ▶ Is a separate impairment approach for E&E assets necessary?
 - ▶ With appropriate measurement basis and clarity on the unit of account concept
 - ▶ Shift in burden of proof, from “why carried” to “why expensed”?

Disclosures

▶ Proposal

- ▶ Reserve quantities by commodity (and by country or project)
 - ▶ Proved and proved plus probable
 - ▶ Main assumptions, sensitivity analysis
 - ▶ Reconciliation of changes
- ▶ Current value measurement and reconciliation of changes
- ▶ Exploration, development and operating cash flows for the current period and as a time series
- ▶ Production revenues by commodity
- ▶ Publish What You Pay disclosures

Disclosure- observations from responses

- ▶ Reserves
 - ▶ Probable reserves- large oil and gas respondents advocated optional disclosure
 - ▶ Heightened risk and uncertainty- litigation and compliance costs
 - ▶ Commercial sensitivity- concern from mining sector re disclosure of quantitative assumptions
 - ▶ Sensitivity analysis- inputs into reserve and resource estimates are non-linear- loss of meaning and value if a single input is changed

- ▶ Current value disclosures
 - ▶ Complexity and significant judgment involved reduces usefulness
 - ▶ Appropriate for IASB to require current value disclosures by the extractive sectors only?

- ▶ Differences to US GAAP
 - ▶ Disclosure of key assumptions and reserve sensitivities/ probable reserves
 - ▶ Need for IASB to work with FASB/SEC and other regulators

- ▶ Cost/ benefit?

- ▶ Publish What You Pay

Closing remarks

- ▶ A number of concerns raised by respondents
 - ▶ Differing views from Minerals and Oil and Gas respondents
 - ▶ Challenges in reconciling these views
- ▶ Low response rate from small and medium sized participants
- ▶ Importance of continued engagement by stakeholders with the IASB
- ▶ Many complex areas of accounting not addressed by the DP
 - ▶ Depending on final scope- potential need for future interpretation
- ▶ Considerable way to go before a new IFRS



Thank you

Disclaimer: The views expressed in this presentation are those of the presenter. Information in this presentation is intended to provide only a general outline of the subjects covered.

It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.

 **ERNST & YOUNG**
Quality In Everything We Do