



# IASB discussion paper on extractive activities



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:

- ▶ The extent to which the costs of finding, acquiring and developing minerals and oil and gas reserves and resources should be capitalised
- ▶ The methods of depreciating or amortising capitalised costs
- ▶ 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
- ▶ The definition and measurement of minerals and oil and gas reserves and resources

## Introduction

On 11 August 2009, the IASB made available a working draft of a Discussion Paper *Extractive Activities*. On 6 April 2010, the IASB published the Discussion Paper for comment. The Discussion Paper presents the results of the research project and contains the views of the project team, which is comprised of staff from the national standard setters in Australia, Canada, Norway and South Africa. The Discussion Paper does not represent the views of the Board. After considering the responses received on the Discussion Paper, the Board will decide whether to add this project to its active agenda.

The purpose of this publication is to summarise the main findings and recommendations included in the Discussion Paper.

## Scope and approach

The Discussion Paper proposes that the scope of an extractive activities standard should include only upstream activities for minerals, oil and natural gas. This represents a change from IFRS 6 *Exploration for and Evaluation of Mineral Resources*, which includes minerals, oil, natural gas and similar non-regenerative resources within its scope. The project team decided against a broader scope because this might result in the need to develop additional definitions, accounting models and disclosures.

There are considerable similarities in the reserve and resource definitions used in the minerals and oil and gas industries. In addition, overlap exists in the financial reporting issues that these industries face. The project team therefore proposes that there should be a single accounting and disclosure model that applies to all extractive activities.



## Definitions of reserves and resources

Reserves refer to the quantity of minerals or oil and gas that is estimated to be economically recoverable from the earth, while resources refer to the quantity of minerals or oil and gas that has been discovered but is not yet capable of being classified as a reserve.

The Discussion Paper explores a number of alternatives for defining reserves and resources. As the IASB does not have the required technical expertise to develop and maintain a comprehensive set of reserve and resource definitions, the project team proposes to rely on the following existing definitions of reserves and resources:

- ▶ Minerals industry – *International Reporting Template for the Public Reporting of Exploration Results, Minerals Resources and Mineral Reserves* (CRIRSCO Template) established by the Committee for Mineral Reserves International Reporting Standards (CRIRSCO)
- ▶ Oil and gas industry – *Petroleum Resource Management System* (PRMS) established by the Society of Petroleum Engineers (in conjunction with other industry bodies)

The project team believes that the CRIRSCO Template and the PRMS are widely accepted and are comprehensive classification systems that cover many types of minerals and oil and gas. They also believe that the nature and extent of the similarities that exist between the CRIRSCO Template and the PRMS reserve and resource definitions indicate that these definitions are capable of providing a platform for setting comparable accounting and disclosure requirements for both minerals and oil and gas assets. Nonetheless, there is some tension between the definition of an asset in the IASB's *Framework* and the assumptions underlying the reserves and resources definitions.

Specifically, the economic assumptions used in estimations are not sufficiently based on market evidence. Also, the definitions incorporate management's intention, which are not a feature of the *Framework*'s definition of an asset.

## Asset recognition

### Definition

The IASB's *Framework* defines an asset as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The Discussion Paper proposes that legal rights (i.e., exploration rights and extraction rights) should form the basis of the minerals or oil and gas asset. An asset should be recognised when the legal rights are acquired. Associated with these legal rights is information about the (possible) existence of minerals or oil and gas, the extent and characteristics of the deposit, and the economics of their extraction. While such information does not represent a separate asset, the project team proposes that information obtained from subsequent exploration and evaluation activities and development works would be treated as enhancements of the legal rights asset. Under this model, costs incurred prior to the acquisition of a legal right would generally be expensed.

### Unit of account

One of the key issues in the development of accounting standards is the decision about the level at which an entity should separately account for assets, i.e., what the 'unit of account' should be. The definition of the unit of account has significant accounting consequences. For example, it determines whether recognition, measurement and disclosure requirements need to be applied by region, country, contract, geological unit or organisational unit. While the IASB's conceptual framework project has identified the definition of a unit of account as an important issue, this has not yet been addressed.



In the context of extractive activities, the Discussion Paper proposes that, "... the unit of account would initially be defined according to the exploration rights held. As exploration and evaluation takes place, the size of the unit of account would contract so that by the time of development and production the geographical dimension of the unit of account would ultimately be no greater than a single area, or group of contiguous areas, for which the rights are held, which is managed separately and which would generate largely independent cash flows."

In addition, the project team's view is that "the components approach in IAS 16 *Property, Plant and Equipment* may be useful in considering which assets should be recognised separately from the legal rights to extract minerals or oil and gas." However, an entity may decide to account for its assets using a smaller unit of account.

### **Asset measurement**

#### *Measurement at historical cost*

The Discussion Paper considers both current value (e.g., fair value or standardised measure of future discounted net cash flows) and historical cost as the potential measurement bases for minerals and oil and gas properties. The findings from the user interviews conducted were that:

- ▶ With some exceptions, historical cost information is not useful because the accumulated costs incurred to find minerals or oil and gas deposits are not helpful in predicting the future cash flows from that property.
- ▶ Measurement of minerals or oil and gas properties at fair value in the balance sheet is not considered useful because the inputs required to calculate fair value are subjective and have a high degree of uncertainty (e.g., recoverable quantity of minerals or oil and gas) and the measurement would lack significant observable market inputs. This would result in information that may not be

- ▶ reliable or comparable. Users indicated they would not directly use management's estimate, but would apply their own judgment in developing inputs to their own value estimates. They would only make use of a fair value provided by the entity if there was extensive disclosure of the assumptions used so they could cross-check the measurement against their own estimates.
- ▶ Current value measurements prepared on the basis of standardised assumptions (e.g., the use of a 10 per cent discount rate, average prices and year-end costs) might be less subjective, more consistent between entities and less costly to produce. However, the specified inputs are unlikely to be consistent with users' views of the inputs relevant to the determination of value.

The project team acknowledges that historical cost and a current value measurement other than fair value generally do not provide relevant information. In addition, because of the subjectivity and degree of estimation involved, users would not use company prepared fair value estimates without significant disclosure surrounding the assumptions. The significant costs involved in preparing fair value information that users indicate is not relevant, led the project team to conclude that minerals and oil and gas properties should be measured at historical cost. The project team acknowledges that its choice of historical cost as the measurement basis is based to a large extent on doing the 'least harm'. The key finding from the user interviews is that detailed disclosures about reserves should be provided to enhance the relevance of the financial statements, whether historical cost or fair value measurement is used.

#### *Impairment*

The project team does not think that applying an alternative impairment model for minerals and oil and gas properties to that in IAS 36 *Impairment of Assets* is justified. However, they believe the IAS 36 impairment model is not feasible for

exploration properties for two reasons. Firstly, estimating the recoverable amount for exploration properties each reporting period is likely to involve as much effort as adopting a fair value measurement basis. Secondly, it may not be possible to limit the number of properties which require an impairment test by using impairment indicators based on adverse changes or new information.

The project team believes that an exploration property should be written down to its recoverable amount only when management has enough information to make the determination. This information is generally not likely to be available while exploration and evaluation activities are ongoing. Accordingly, exploration properties would be written down only when there is a high likelihood that the carrying amount would not be recoverable in full. A separate set of indicators would be applied to exploration properties to assess whether they can continue to be recognised as assets.

As significant judgment is involved in determining whether an exploration property should be written down, the project team believes there should be separate presentation of exploration properties in the financial statements and disclosure of the factors that led to a write down or why exploration properties that were not written down continue to be capitalised.

### **Disclosure**

Given the limited relevance that users place on recognition and measurement of minerals and oil and gas properties, the Discussion Paper proposes extensive disclosures that aim to provide users of financial reports with sufficient information to evaluate:

- ▶ The value attributable to an entity's minerals and oil and gas properties
- ▶ The contribution of those assets to current period financial performance
- ▶ The nature and extent of risks and uncertainties associated with those assets

The Discussion Paper proposes detailed disclosures about the quantities of reserves and resources, and production revenues and costs. If the assets are measured at historical cost, then detailed information should be disclosed about their current value and how it was determined. If, instead, the assets are measured at fair value then detailed information should be disclosed about that fair value and how it was determined. Table 1 summarises the proposed disclosures.

The survey of users found that many did not believe an independent audit of reserves information was necessary. That, in addition to the significant cost associated with performing an audit of reserves led the project team to recommend that the disclosures not be required in the notes to the financial statements if they are disclosed elsewhere within the financial statements.

### **Publish What You Pay proposals**

A coalition of non-governmental organisations is promoting a campaign called Publish What You Pay (PWYP), which proposes that entities undertaking extractive activities should be required to disclose, in their financial reports, the payments they make to each host government. PWYP also proposes that disclosures should be provided on a country by country basis for other types of information including minerals and oil and gas reserve quantities, production volumes, production revenues, costs incurred in development and production and key subsidiaries and properties.

The Discussion Paper notes that the disclosure of payments made to governments provides information that would be of use to capital providers in making their investment and lending decisions, but notes that providing this information might be difficult and costly for some entities. The project team is seeking to develop an understanding whether a requirement to disclose this information is justifiable on cost-benefit grounds.

### **Next steps**

Comments are to be received on the Discussion Paper by 30 July 2010. The IASB will consider the Discussion Paper's analysis, proposals and the comment letters received in determining whether to add the project to its active agenda. At that time, the Board will decide whether it would be appropriate to proceed to the development of an exposure draft or whether it should publish its own discussion paper.

Given the divergence that exists in current practice, companies should not miss the opportunity to influence the direction of the project given it is at an early stage. Look for more thought leadership from Ernst & Young on the Discussion Paper in the coming months.

For more detail on the findings and recommendations included in the Discussion Paper, it is available at; [www.iasb.org](http://www.iasb.org), under IASB projects.

**Table 1**

The project team proposes the following disclosures:

- ▶ *Reserve quantities by commodity, and further broken down by country or project:* proved reserves and proved and probable reserves, estimation method, main assumptions, sensitivity analysis to main assumptions and reconciliation of changes in reserve quantities
- ▶ *Current value measurement:* if the asset is measured at historical cost, as proposed by the project team, then the following information should be disclosed for each major geographical region:
  - ▶ Current value information based on either a:
    - ▶ Range of estimates based on fair value measurement principles or
    - ▶ Standardised measure of proved and probable reserves, which is preferred by the project team
  - ▶ Preparation basis
  - ▶ Main assumptions
  - ▶ Reconciliation of changes in current value
- ▶ *Fair value measurement:* if asset is measured at fair value, disclose the fair value estimate, main assumptions, sensitivity analysis to main assumptions, reconciliation of changes in reserve values and other disclosures similar to the proposals in ED *Fair Value Measurements*
- ▶ *Production revenues by commodity*
- ▶ *Costs:* a five year time series, disaggregated at the same level as the reserves disclosure, of exploration, development and production costs.

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