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Fossil Energy and Mineral Resources Terminology

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INTERNATIONAL ACCOUNTING STANDARDS BOARD'S RESEARCH PROJECT ON EXTRACTIVE ACTIVITIES

Briefing on the International Accounting Standards Board's Discussion Paper on Extractive Activities

Note by the secretariat[1]

Summary

At previous sessions of the Ad Group of Experts on Harmonization of Fossil Energy and Mineral Resources Terminology, there have been presentations on the activities of the Extractive Industries Research Project of the International Accounting Standards Board (IASB). Since the meeting of the sixth session of the Ad Hoc Group of Experts, the IASB project team has released a discussion paper on the IASB website. This note serves to summarize the key issues raised in the discussion paper.

[1] This document was submitted late due to delayed inputs from other sources.

INTRODUCTION

1. The Ad Hoc Group of Experts on Harmonization of Fossil Energy and Mineral Resources Terminology has been looking at the issue of financial reporting standards for extractive activities for a number of years and, in particular, developments relating to the Research Project on Extractive Activities of the International Accounting Standards Board (IASB).

2. At its sixth session the Ad Hoc Group of Experts agreed that a paper summarizing key extracts from the IASB Extractive Activities Research Project Discussion Paper should be prepared for the seventh session (ECE/ENERGY/GE.3/2009/2 para 46. (e)).

3. The minerals and oil and gas industries are an important part of the international capital markets. The absence of comprehensive guidance has contributed to significant divergence in financial reporting for extractive activities under International Financial Reporting Standards, which is one of the main reasons for IASB undertaking the Extractive Industries Project. 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;

(d) the definition and measurement of minerals and oil and gas reserves and resources.

4. In July 2009, IASB decided to defer publication of its Extractive Activities discussion paper until early in 2010, in order to manage its workload. A working draft of the discussion paper was made available on the IASB website on 11 August 2009 for the information of interested observers.

5. The working draft presents the project team's findings and recommendations as a result of their research. The questions included in the working draft are provided for illustrative purposes only and comments are not requested at this time. Although IASB has discussed the Extractive Activities Project team's findings, it has not developed preliminary views on the project team's recommendations.

6. The purpose of this note is to summarize the main findings and recommendations included in the working draft.

I. SCOPE AND APPROACH

7. The working draft proposes that the scope of an extractive activities standard should include only upstream activities for mineral, oil and natural gas. This represents a change from International Financial Reporting Standard (IFRS) 6 *Exploration for and Evaluation of Mineral Resources*, which includes minerals, oil, natural gas and similar non-regenerative resources

within its scope. The IASB extractive activities research project team decided against a broader scope because this might result in the need to develop additional definitions, accounting models and disclosures.

8. There are considerable similarities in the reserve and resource definitions used in the minerals and oil and gas industries. In addition, considerable 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.

II. DEFINITIONS OF RESERVES AND RESOURCES

9. 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.

10. The working draft explores a number of alternatives for defining reserves and resources. As 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:

(a) Minerals industry – International Reporting Template for the Public Reporting of Exploration Results, Minerals Resources and Mineral Reserves (Committee for Mineral Reserves International Reporting Standards (CRIRSCO) Template) established by CRIRSCO;

(b) Oil and Gas industry – Society of Petroleum Engineers/World Petroleum Congress/American Association of Petroleum Geologists/Society of Petroleum Evaluation Engineers Petroleum Resources Management System (SPE-PRMS).

11. The CRIRSCO Template and SPE-PRMS are widely accepted and are comprehensive classification systems that cover many types of minerals and oil and gas. The project team believes 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.

12. While the project team recommends the use of the CRIRSCO Template and SPE-PRMS, it also recommends that the alternative option of using the United Nations Framework Classification for Fossil Energy and Mineral Resources (UNFC) should be reconsidered if an extractive activities project is added to the IASB's active agenda.

III. ASSET RECOGNITION

A. Definition

13. 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.

14. The working draft 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 recognized 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. The project team believes that rights and information associated with minerals or oil and gas properties satisfy the asset recognition criteria. 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.

15. The project team considered whether it would be possible to develop an accounting model for extractive activities that focuses on phases of activities. This approach was rejected because it might result in conflicts with the definition of an asset in the IASB's Framework and further difficulties might arise in developing a clear and coherent definition of each phase.

B. Unit of account

16. One of the key issues in the development of accounting standards and in the selection of accounting policies by preparers 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 organizational unit. While IASB's conceptual framework project has identified the definition of a unit of account as an important issue, this has not yet been addressed.

17. In the context of extractive activities, the working draft proposes that "…the geographical boundary of the unit of account would initially be defined according to the exploration rights held. As exploration, evaluation and development activities take place, the unit of account will progressively contract until it becomes no greater than a single area, or group of contiguous areas, for which the legal rights are held and which is managed separately and would be expected to generate largely independent cash flows. In addition, the project team's view is that the components approach in International Accounting Standards (IAS) 16 *Property, Plant and Equipment* should apply in determining the items that are accounted for as a single asset". However, an entity may decide to account for its assets using a smaller unit of account.

IV. ASSET MEASUREMENT

A. Measurement at historical cost

18. The working draft considers both current value (e.g. as fair value) and historical cost as potential measurement bases for minerals and oil and gas assets. The findings from the user interviews were that:

(a) With some exceptions, historical cost information is not useful because the accumulated costs incurred to find a minerals or oil and gas deposit are not helpful in predicting the future cash flows from that property;

(b) Measurement of minerals or oil and gas properties at fair value in the balance sheet is not considered useful because there are many significant variables that go into a valuation and there can be substantial subjectivity involved. Users consider it important to apply their own judgement to these factors rather than relying on management's judgement. They would only make use of a fair value provided by the entity if there was extensive disclosure of the assumptions used;

(c) Current value measurements prepared on the basis of standardized assumptions (e.g. the use of a 10 per cent discount rate and year-end prices and costs) might be less subjective, more consistent between entities and less costly to produce. However, the more the inputs are specified the less likely it is that the valuation will be relevant.

19. Based on these findings the project team concluded that minerals and oil and gas assets should be measured at historical cost and that detailed disclosures should be provided to enhance the relevance of the financial statements. 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 final Discussion Paper will therefore ask commentators what measurement basis should be used for minerals and oil and gas assets.

B. Impairment

20. The IAS 36 *Impairment of Assets* model is not considered to be feasible for exploration properties for two reasons. Firstly, estimating the recoverable amount for exploration properties at each reporting period is likely to involve as much effort as adopting a current value measurement basis. Secondly, it is not possible to limit the number of properties which require an impairment test by using impairment indicators based on adverse changes or new information.

21. The project team believes that exploration properties should only be tested for impairment whenever evidence is available to suggest that full recovery of the carrying amount of an exploration asset is unlikely. That means that exploration properties need not be tested for impairment if the evidence needed to make that assessment was not yet available or was inconclusive. If that were the case an entity would be required to disclose why it considers that the carrying amounts of its exploration assets are not impaired. However, other aspects of IAS 36 should apply, such as the requirements on measuring recoverable amount, recognizing the impairment loss and disclosure.

V. DISCLOSURE

22. The working draft proposes extensive disclosures that are aimed to ensure that users of financial reports can evaluate:

(a) the value attributable to an entity's minerals and oil and gas assets;

(b) the contribution of those assets to current period financial performance;

(c) the nature and extent of risks and uncertainties associated with those assets.

23. The working draft 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. The proposed disclosures are summarized in the box on page 7.

VI. PUBLISH WHAT YOU PAY PROPOSALS

24. A coalition of non-governmental organizations 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.

25. The working draft 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.

VII. NEXT STEPS

26. No more education sessions with the Board are planned prior to the publication of a request for views on the project team's discussion paper in the first quarter of 2010. After publication of its request for views, the Board must make a decision about adding the project to its active agenda. Once that decision has been made, the project team estimates that an exposure draft would take at least 18 months to develop and that a final IFRS would take at least another 12 months to develop.

27. Additional details on the findings and recommendations are included in the working draft, which is available on the IASB website, under IASB projects.[2]

Disclosures proposed by IASB Extractive Activities Research Project Team

The project team proposes the following disclosures:

(a) *reserve quantities by commodity, and further broken down by country or project:*
- (i) proved reserves and proved and probable reserves;
- (ii) estimation method;
- (iii) main assumptions;
- (iv) sensitivity analysis to main assumptions;
- (v) reconciliation of changes in reserve quantities;

(b) *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:
- (i) current value information based on either:
  - a. a range of estimates based on fair value measurement principles;
  - b. a standardized measure of proved and probable reserves, which is preferred by the project team;
- (ii) preparation basis;
- (iii) main assumptions;
- (iv) reconciliation of changes in current value;

(c) *fair value measurement:* if asset is measured at fair value:
- (i) fair value estimate;
- (ii) main assumptions;
- (iii) sensitivity analysis to main assumptions;
- (iv) reconciliation of changes in reserve values;
- (v) other disclosures similar to the proposals in ED/2009/5 *Fair Value Measurements;*

(d) *production revenues by commodity;*

(e) *costs:* a five year time series, disaggregated at the same level as the reserves quantity disclosure, of
- (i) exploration costs;
- (ii) development cost;
- (iii) production costs.

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[2] http://www.iasb.org/Current+Projects/IASB+Projects/Extractive+Activities/Summary.htm