



Blending
convention with
innovation

The IASB Working
Group's Extractive
Industries' 2009
Discussion Paper

In August 2009, the IASB Working Group on Extractive Industries published a “working draft” of a Discussion Paper (“the DP” or “working draft”) on extractive industries as a first step towards the production of definitive standards. The working draft addresses a limited number of issues that are of particular importance to the mining and upstream oil and gas industries.

These include:

- the definitions of reserves and resources;
- asset recognition criteria for extractive activities;
- asset measurement criteria for those properties;
- disclosure recommendations; and
- “Publish What You Pay” proposals.

The working draft does not address all aspects of IFRS standards for which there are issues specific to mining. The Issues Paper entitled “The Extractive Industries” published by the IASB in 2000 considered some of these, including determining the depreciation base and rates for depreciating mineral properties. The current working draft is aimed at the higher level issues of recognition, measurement and disclosure of mineral properties. It identifies “the most important information” in financial statements as that which provides information about the minerals or oil and gas reserves and resources under the entity’s control, and aspires to identify a single accounting model for all extractive industries including not only mining, but also oil and gas and resources such as oil sands. This includes how such assets should be recognized on initial recognition – at fair value or at historical cost – and how they should be measured subsequently for the purposes of the income statement and balance sheet, as well as disclosure. Heading 1 in sentence case

Users’ expectations as a background

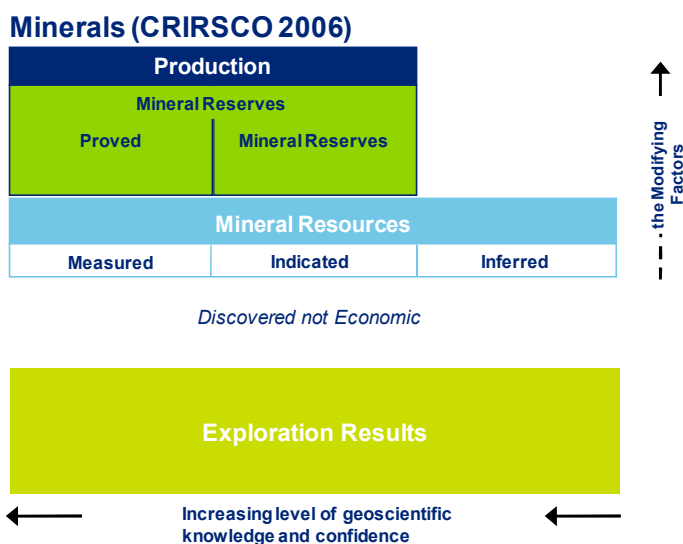
Before developing the DP, the project team interviewed 34 professional users of financial statements, including analysts, venture capitalists and lenders, to obtain some background on users’ expectations of financial statements. The results of these interviews colour many of the conclusions contained in the working draft. These include the observations that:

- Historical cost information in the balance sheet on extractive resources does not generate useful information, whether prepared under the full cost, successful efforts, or area of interest method;
- There is some interest in the reporting of “finding costs” per unit of revenues – although on a total expenditure basis rather than simply on a recognized asset basis;
- Recording fair values in the balance sheet would not generate useful information – in the opinion of users, there are too many significant variables which would be subject to substantial subjectivity; and
- Valuations prepared using certain specified assumptions – such as those required for oil and gas entities using stipulated prices and discount rates – may be useful if they provided insights on the nature of year-to-year changes in reported reserves.

The survey disclosed that users want information about reserves and resources, development and production costs, and changes therein over time, disaggregated by products and grades. In Canada and the United States, many of these matters are already contained in reserve reports prepared in accordance with securities regulations and filed separately from the financial statements. However, the DP, conceived as part of a global set of standards to be applied without reference to the specific requirements of jurisdictions, does not contemplate whether such information already exists in other forms when developing its recommendations. Hence some of the recommendations may appear redundant in the Canadian regulatory environment.

Definitions of reserves and resources

For the purposes of defining reserves and resources, the working draft recommends that entities employ the CRIRSCO template 1 for describing mining reserves and resources. This template is similar (if not practically identical) to the Canadian Institute of Mining (CIM) template.



Some of the attributes of this template are:

- The financial assumptions used in reserve estimates should be the entity’s own internal forecasts of future conditions over the life of the project – “realistically assumed.” These assumptions may not be consistent with those employed in a “fair value” estimate – for example, long-term estimates of exchange rates would be entity-specific estimates;
- There is a category of “possible” reserves, being an incremental estimate of recoverable quantities above and beyond proved reserves;
- A category of “inferred” resources exists but is sufficiently uncertain to be primarily the focus of disclosure rather than measurement (note that the DP does not directly consider the recognition of value beyond proven and probable reserves (“VBPP”) in business combination accounting) and impairment; and
- Discount rates would be the entity’s cost of capital – an entity-specific estimate, also not consistent with fair values.

Notably, the proposals of the working draft do not agree with the SEC position that excludes the disclosure of mineral reserves and resources other than proven (unless otherwise required). Also, the treatment of VBPP in business combinations is a significant issue that has been addressed by both the EITF and the EIC and would seem to be an important issue to resolve in IFRS.

¹ CRIRSCO is the Committee for Mineral Reserves International Reporting Standards (CRIRSCO), an international organization of geologists.

Asset recognition and measurement

The DP proposes a new conceptual approach to the measurement of mineral assets – also somewhat at variance with both the IASB’s conceptual framework and current practice. The ideas expressed in the DP are that initial expenditures provide legal rights to a property, and that subsequent exploration and evaluation expenditures generate “information” that improves the entity’s knowledge about a specific site. All such expenditures would be capitalized into the asset.

The DP considers expensing all exploration and development costs a bad thing: “recognizing exploration and development as expenses...would seriously misstate the statement of comprehensive income.” Specifically, “unsuccessful exploration can improve the understanding of the geology...and therefore can represent an enhancement to the legal right asset.” Thus “the cost of these activities should be capitalized because they are an enhancement to the asset even though sufficient information may not yet be available to indicate the existence of economically recoverable reserves.”

Capitalized costs would therefore consist of all expenditures to acquire legal rights and information – regardless of what that information reveals. There is also recognition that exploration, evaluation and development may occur simultaneously. Hence, the capitalization process would not be a function of the phase of the project. Specifically, “information obtained from subsequent exploration and development works ... [should] both be treated as enhancements of the legal rights’ asset.” However, the DP proposes to test exploration properties for impairment “whenever evidence is available to suggest that full recovery is unlikely.”

The concept that knowledge or information is the foundation for recognizing an asset is somewhat different from the focus of the conceptual framework and other IFRS standards such as those on impairment. These focus on measures that are derived from or are useful in making estimates of future cash flows. Hence the approach of the DP represents a divergence from other IFRS standards that are consistent with the framework (although currently not all IFRS standards are consistent with it). The DP’s approach also does not support the use of fair value. This may be a challenge if the project’s proposals are to be approved by the IASB, which may expect, at a minimum, consistency of any new standards with the framework.

These proposals cover “exploration rights” – that is, properties that are currently conventionally classified as exploration and development properties. There is a different classification proposed, however, once a property becomes developed or producing: property rights would be classified out of “exploration rights” and into “extraction rights” and would be treated in the same manner as property plant and equipment under IAS 16 and under IAS 36 for the purposes of impairment testing.

The “unit of measure” issue is also addressed: this is the extent to which properties are aggregated or separated for the purposes of accumulating costs or for testing for impairment. Generally the smaller the unit of account the more sensitive the asset is to the conditions of impairment. The DP proposes that the unit of account for exploration or extraction rights would be defined as a single area or group of contiguous areas managed separately. Usually this would be a single mine or exploration prospect. Elements that are not integral – such as rigs, buildings, etc. – would be separate units of account depreciated separately, and would be fact- and circumstance-specific.

This discussion also considers the recognition of reserves beyond proven and probable. It is recognized that the acquirer of a property “in effect also acquires an option on potential improvements to future cash flow and this option will affect fair value.” This option “would take into account potential upside to reserves” not otherwise included. However, financial statement users noted that “the independent assessment (by the user) of the various uncertainties is a critical part of their role...relying on management’s assessment of these factors is inconsistent with this.” Thus, such reserves are considered primarily as disclosure items.

Perhaps the most practically significant conclusion of the DP is that fair value measures are not its recommended choice of measure for either exploration or extractive properties. The IASB has previously indicated that fair valuation of resource properties as a measurement basis should not be ruled out. The DP recognizes that, conceptually, a fair value measure might be the most suitable measure for mining properties. However, it notes that if a fair value model was employed, such fair values would have to be re-measured at each reporting period, including interim periods. The DP notes that this would clearly be impractical in the North American quarterly reporting environment; thus, measuring such assets at fair value “does not meet a cost-benefit test.” It is also noted that in mining there may be zero correspondence between the cost of a property and its fair value: fortuitous discoveries may generate huge fair values for zero cost.

The conclusion of the DP is that choosing a measurement basis for mineral properties is essentially a choice of the lesser of two evils; the historical cost method is therefore recommended by the DP as it does “the least harm.”

Disclosure

Another significant conclusion of the DP is that the answer to user needs lies not in the measurement and recognition standards, but in the disclosures about reserves. Consequently, the DP proposes disclosure that includes much of the information that is currently reported outside the financial statements in regulatory filings. These include such matters as:

- Separately for each commodity:
 - Expressing estimates of recoverable quantities at different confidence levels, such as proven, proven plus probable (aggregated), and beyond proven and probable;
 - Presenting the information separately for properties subject to different risks, such as market and political risks;
 - Disclosing main assumptions and sensitivity analyses for variations in those assumptions; and
 - Providing explanations of changes in such categorized amounts from year to year.
- If the historical cost model is used to measure mineral properties:
 - Disclosing a range of fair values for mining properties, disaggregated by type or country, or
 - Disclosing a standardized measure of reserves, similar to that required by FAS 61 for oil and gas reserves, e.g. using year-end spot prices discounted at a uniform rate of 10%, with changes in the annual amounts analyzed by cause – i.e. production, additions, dispositions, changes in estimates, reclassifications, etc.
- Production revenues by commodity; and
- Five years’ data outlining costs or capital expenditures, analyzed as exploration, development, and production.

It is the view of the Working Party that the disclosure of reserves is not a regulatory matter, but an element of the financial statements, similar to the disclosures of biological assets in IAS 41.

Additional disclosures provide insights on other IFRS reporting matters that affect mining. For example, disclosure would be made of:

- The nature of carve-outs: the revenue from total production would be shown as revenue, and each type of payment from that revenue would be shown as an expense;
- Minority interests in reserves, as well as total controlled reserves;
- Sensitivity of reserves to changes in price assumptions (a matter 31% of a sample of mining entities already disclosed in 2008); and
- Disclosure of production revenues by commodity by physical quality or by cash flows, for the latest five years, and by major geographical area.

“Publish What You Pay” proposals

The last issue concerns the disclosure of all payments made by an entity to governmental authorities – a topic that has as much to do with the reporting by government authorities as it does with corporate reporting. This topic appears to be tangential to the major focus of the DP, which is on the recognition and measurement of mineral resources. Hence, the “Publish What You Pay” proposals will not be discussed here. The interested reader is encouraged to consider the working draft for further information on this topic

Observations on the Discussion Paper: A blend of novelty and convention

The DP is described by the Working Party as a work in progress. It is somewhat unconventional in its approach in that it specifically contemplates user needs for information about mining properties, rather than deriving its recommendations simply from a consideration of the conceptual framework. It thus challenges the utility of fair values, which is somewhat counter to the general preference traditionally shown by the IASB for fair value measurements. It defines the utility of capitalizing exploration activities in terms of information generation rather than in terms of future cash flows. To this extent it expressly deals with the significant uncertainty that pervades the mining sector. It considers the issue of VBPP as a matter of “upside potential” and option-like attributes, also a novel approach to asset measurement in IFRS (or Canadian or U.S. GAAP).

At the same time, it recommends conventional historical cost measures of mineral resources on the basis that such measures cause the least harm. User needs for information that is relevant to the estimation of future cash flows, and their associated risks, are to be satisfied by extensive disclosure requirements that would employ either current value or a standardized measure, such as required by FAS 61 for oil and gas assets as well as sensitivity analysis to significant variables. Breakdowns of revenue by commodity and region further provide users with insights that are similar to those found in segmented reporting.

The novelties of the DP demonstrate that the working group is looking for new solutions to reporting challenges that have been with the industry for some time. At the same time this may be the weakest element of the approach as the IASB may not be willing to vary from its framework to recognize that, uniquely in the extractive industries, sunk costs generally have very little relevance to the entity’s operating decisions or to its future cash flows. And analysts consider managements’ estimates as too subjective to merit consideration: they would rather make such estimates on their own. In contrast to the DP’s proposals, fair values are generally becoming the preferred basis of measurement for most financial instruments, and for many other items. In this light, the uniqueness of the DP’s approach stands out.

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