



8 April 2010

To: **Members of the Hong Kong Institute of CPAs**
All other interested parties

INVITATION TO COMMENT ON IASB DISCUSSION PAPER ON *EXTRACTIVE ACTIVITIES*

Comments to be received by 16 July 2010

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Discussion Paper which has been posted on the Institute's website at:

<http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/>.

A research team comprising members of the Australian, Canadian, Norwegian and South African accounting standard-setters analysed and discussed accounting for extractive activities with a wide range of stakeholders in order to identify a possible approach for a standard on the accounting for extractive activities. The Discussion Paper only contains the views of the project team – it does not represent the views of the IASB. After considering the responses received on the Discussion Paper, the IASB will decide whether to add the project to its active agenda.

Extractive activities are the activities undertaken by entities when searching for, and ultimately extracting, minerals, oil or natural gas. The area of extractive industries poses some very specific challenges resulting from the uncertainties that are faced by entities pursuing extractive activities: for instance assessing the quantities that may be found and the costs involved in accessing and extracting the resources.

The current standard, IFRS 6 *Exploration for and Evaluation of Mineral Resources*, was issued in 2004 as an interim standard pending completion of this research project. Existing IFRSs do not specifically address the accounting for the development and production of minerals or oil and gas properties, and do not include specific disclosure requirements that would help users to assess the nature and extent of the risks involved in the extractive activities. Because of the lack of guidance on these issues, the accounting and disclosure practices of entities engaged in extractive activities often vary by industry, by jurisdiction, and by the size of the company.

This Discussion Paper discusses how a possible standard on extractive activities could address these issues, thereby improving the relevance and comparability of financial statements.

--- A summary prepared by the IASB on the Discussion Paper is set out in the attached Appendix.

In accordance with the Institute's Convergence Due Process, comments are invited from any interested party. The FRSC would like to hear from both those who do agree and those who do not agree with the proposals contained in the IASB Discussion Paper.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IASB Discussion Paper to be considered, they are requested to be received by the Institute on or before **16 July 2010**.



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

Snapshot: Extractive Activities Discussion Paper

This snapshot introduces the results and proposals of a research project on the accounting and disclosure requirements for extractive activities as published in a discussion paper – *Extractive Activities*. As such, it does not represent the official views of the Board.

The project was conducted by a project team of national standard-setters from Australia, Canada, Norway and South Africa for the International Accounting Standards Board (IASB).

Project objective:

The objective of the research project is to analyse the unique financial reporting issues applicable to extractive activities, and to identify a basis on which a financial reporting model might be developed to address them. The research findings, including the comments received on this discussion paper, will assist the IASB in deciding whether to develop an IFRS for extractive activities and to decide upon the content of that IFRS.

Project stage:

The IASB published the project team's discussion paper on 6 April 2010. It follows the release of a working draft of the discussion paper in August 2009. The discussion paper was developed after consulting extensively with industry participants to identify and analyse financial reporting issues associated with extractive activities.

Comment deadline:

The IASB invites comments on the discussion paper by 30 July 2010.



What are extractive activities?

Extractive activities are the activities undertaken by mining and oil and gas entities when searching for, and ultimately extracting, minerals or oil and gas.

The activities involve the following four phases:

1. **exploration:** the search for deposits of minerals or oil and gas;
2. **evaluation:** assessing the quantity and quality and viability of the deposits found and the economic viability of their extraction;

3. **development:** undertaking works to access the deposit and to construct the infrastructure necessary to extract the minerals or oil and gas; and

4. **production:** the extraction of the minerals or oil and gas from those deposits.

The activities are collectively known as extractive activities.

Why undertake this research project?

The mining and oil and gas industries form a significant part of the world's economy, and the entities that participate in extractive activities, play a major role in the world's capital markets.

The unique financial reporting challenges that these entities face, are not, however, addressed in existing IFRSs.

In particular:

- IFRSs do not provide specific guidance for exploration, evaluation, development and production of minerals or oil and gas. This has resulted in diversity of accounting practice.

- Some of the practices applied are not compatible with the general principles within IFRSs. Consequently, some commentators have questioned the relevance and quality of those accounting policies.
- Users need more information about the nature and extent of the risks within an entity's extractive activities. For instance, existing IFRSs do not specifically require disclosure of information about the entity's minerals or oil and gas reserves. Some securities regulators and stock exchanges have requirements for the disclosure of this type of information, although the requirements often vary, and consequently entities with similar assets may be disclosing different information.

Many believe that an IFRS for extractive activities is needed to address these concerns.

What are the challenges that distinguish extractive activities?

There are significant risks and uncertainties inherent in extractive activities that distinguish that area from other industry sectors.

In particular, these risks and uncertainties include:

Exploration risk

The exploratory nature of the industry gives rise to the risk that exploration activities might not lead to the discovery of a minerals or oil and gas deposits.

Uncertainty in the quantity that can be extracted

Geological variations in each deposit discovered lead to uncertainty in the quantity of minerals or oil and gas that are present in the deposit and that are capable of being extracted.

Uncertainty of commodity prices

The volatility of prices in the commodity markets in which the minerals or oil and gas produced will be sold creates uncertainty over the quantity of minerals or oil and gas that can be economically extracted, and also about the value that can be realised from the ultimate sale of the minerals or oil and gas.

The unique financial reporting challenges that these entities face are not addressed in existing IFRSs.

Uncertainty in the costs involved

The complexity of the physical access to the deposits and the harsh climates in which many deposits are located, and the long time needed to construct the necessary infrastructure for extraction, give rise to uncertainty in the costs of access and extraction and, in some cases, uncertainty about the overall project viability.

What is the current financial reporting response to these challenges?

The current standard that applies to extractive activities, IFRS 6 *Exploration for and Evaluation of Mineral Resources*, was developed as an interim standard in 2004.

IFRS 6 *Exploration for and Evaluation of Mineral Resources* was developed as an interim standard until the IASB had time to address financial reporting comprehensively. IFRS 6 permits a continuation of previous accounting policies for exploration and evaluation activities.

Many of the policies applied have been carried over from previous GAAP when entities adopted IFRSs, leading to diversity in financial reporting. In addition, several such policies fail to adhere to the concepts for financial reporting in the IASB *Framework*.

The lack of comprehensive guidance in IFRS has led entities engaged in extractive activities to develop their own policies, often based on their previous GAAP, to address the financial reporting issues that they face. This has resulted in diversity in financial reporting.

The accounting and disclosure practices of entities engaged in extractive activities often vary by industry, by jurisdiction, and by the size of the company.

This diversity in financial reporting also exists in the development and production phases, because other important IFRSs exclude extractive activities from their scope; specifically IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

The diversity in accounting practices is compounded by the tendency for mining entities to apply different accounting practices from those applied by oil and gas entities, despite both industries having many similar features.

What is the purpose and content of the discussion paper?

The discussion paper sets out the results of the research conducted by the project team, and their proposals for the development of a single accounting and disclosure model for extractive activities.

By publishing the discussion paper, the IASB is seeking input from all those interested in and affected by the accounting for extractive industries on the issues and the approaches proposed by the project team. This input will assist the Board in determining whether to add this project to its active agenda and in establishing the future direction of the project.

Most importantly, the project team proposes a single accounting and disclosure model for extractive activities.

Many previous accounting standard-setting efforts have focused separately on the accounting and disclosure requirements for minerals or oil and gas. This has led to different requirements for the two industries. These differences continue to exist among entities that now apply IFRSs.

To provide the required clarity and comparability, the project team proposes a single financial reporting model for extractive activities. The main business activities of exploration, evaluation, development and production activities are common to both the minerals or oil and gas industries. Entities in the two industries also face similar geological, economic and political risks and uncertainties.

Based on the objective to develop a single financial reporting model for extractive activities the discussion paper addresses the following research questions:

1. How to estimate and classify the quantities of minerals or oil and gas discovered;
2. How to account for minerals or oil and gas properties;
3. How minerals or oil and gas properties should be measured; and
4. What information about extractive activities should be disclosed?

What is the purpose and content of the discussion paper? continued

1. How to estimate and classify quantities of minerals or oil and gas reserves

The project team proposes that a common basis for defining ‘reserves and resources’ – the terms used to describe the quantities of minerals or oil and gas discovered – should be used.

The project team proposes using the Committee for Mineral Reserves International Reporting Standards (CRIRSCO) Template for estimating and classifying minerals reserves and resources and the Petroleum Resource Management System (PRMS), issued by the Society of Petroleum Engineers (SPE), for estimating and classifying oil and gas reserves and resources.

These definitions have wide acceptance within the industry, and are broad and comprehensive in scope. A joint CRIRSCO-SPE working group has confirmed broad equivalency exists between these two sets of industry definitions. The project team’s view is that the equivalency between these definitions provides a basis for building a single financial reporting model across the minerals or oil and gas industries.

How would this be different from current practice?

Currently there are several different definitions used for estimating and classifying reserves and resources for minerals or oil and gas. These different definitions lead to diversity in accounting and in disclosure.

2. How to account for minerals or oil and gas properties

The project team proposes that the initial focus for accounting for minerals or oil and gas properties should be the legal rights to that property. These rights could be exploration rights or extraction rights. The property is recognised as an asset when these legal rights are acquired.

Information obtained from exploration, evaluation activities, and development work that is undertaken to access the minerals or oil and gas deposit, are enhancements to the property, and are accounted for as additions to the minerals or oil and gas property

recognised. As better information about the physical location and characteristics of the minerals or oil and gas deposits is obtained through these activities, an entity may identify separately-distinguishable minerals or oil and gas deposits within the legal rights. When this occurs, separate minerals or oil and gas properties are identified within the legal rights area, and are accounted for as separate assets, on the basis of the refined geological information.

How would this be different from current practice?

The proposed basis for recognising a minerals or oil and gas property as an asset is based on the asset definition

and recognition criteria in the *Framework*. This is in contrast to existing practices, which generally focus on accounting for the separate phases of extractive activities. Many of these are cost-deferral models, and the costs capitalised are subject to carry-forward or write-off on the basis of management decisions to continue with activities in a particular area, or to abandon them. Some of those models are inconsistent with the *Framework* criteria for asset definition and recognition.

3. How minerals or oil and gas properties should be measured

The project team proposes that the minerals or oil and gas properties should be measured at historical cost, supplemented with detailed disclosure about the entity's minerals or oil and gas properties.

An alternative measurement basis that was considered by the project team was a current-value measurement, such as fair value. However, the team's research found that, in general, users did not think that a current-value measurement would provide them with more relevant information than historical cost. Users indicated they wanted additional disclosure to help them prepare their own estimates of the value of an entity's minerals or oil and gas properties.

A historical-cost measurement that is a faithful representation of the cost of acquiring, exploring and developing a property might be useful for assessing management's stewardship of the economic resources entrusted to it by investors and creditors.

Other alternatives considered by the project team were a simplified valuation of reserves, using standardised assumptions, and a measurement approach based on changing from historical cost to fair value at a pre-defined stage in the life of the asset. Neither of these alternatives, in the project team's view, provided sufficiently better information to users than using historical cost, supplemented with detailed disclosures about the entity's minerals or oil and gas properties.

How would this be different from current practice?

Historical cost is the dominant measurement basis within current practice in extractive activities. However, there are various historical-cost based accounting models that are used to recognise and measure minerals or oil and gas properties. In many cases, there are variations across jurisdictions and across industries. The discussion paper proposes a single measurement basis.

What is the purpose and content of the discussion paper? *continued*

4. What information about extractive activities should be disclosed?

The project team proposes to introduce disclosure requirements that would help users to assess the nature and extent of the risks involved in the extractive activities.

The information would enable users of the financial statements to evaluate:

- the value of the entity's minerals or oil and gas properties:
 - the quantities of proved and probable reserves, suitably disaggregated according to the different risks of different properties. This could be on a property, country or regional basis, depending on circumstances;
- a current value measurement of proved and probable reserves, presented by major geographical region;
- the principal assumptions and estimates used to determine reserves quantities and values, and the sensitivity of these quantities and values to changes in those assumptions and estimates.
- the contribution that the minerals or oil and gas properties make to the entity's performance:
 - changes in reserve quantities and values during the period, analysed by the nature of the change;
 - the amount of revenues earned, by commodity;
 - the amount of costs expensed and amounts capitalised, using the same disaggregation as for reserves, and disclosed for an extended time period of 5 years.
- the nature and extent of the risks and uncertainties associated with the entity's minerals or oil and gas properties:
 - the disaggregation used and sensitivity analysis provided in the disclosures support this objective.

How is this different from current practice?

The extent and nature of disclosures varies significantly. Current disclosures are often driven by national or regulatory requirements, many of which have evolved independently and separately for minerals and for oil and gas. Diversity in the reserves definitions used can lead to a lack of comparability when similar information is disclosed.

A wider perspective? Considering the Publish What You Pay proposals

The Publish What You Pay (PWYP) coalition seeks to improve the accountability of governments of resource-rich developing countries for the management of revenues from the minerals or oil and gas industries.

During its research, the project team and members of the IASB have met with PWYP coalition representatives on several occasions to better understand the objectives and requirements of PWYP.

To achieve its objective, the PWYP coalition proposes that entities undertaking extractive activities should be required to disclose in their financial reports:

- a) the payments made to governments. These payments, which could be in cash or in kind, should be disclosed on a country-by-country basis.
- b) other information, including minerals or oil and gas reserve quantities, production quantities,

production revenues and costs incurred in development and production. This information should also be disclosed on a country-by-country basis.

The PWYP coalition considers that the enhanced transparency provided by these disclosures would help to improve governance and promote sustainable development in these countries. The PWYP coalition has suggested that the IFRS should require this information to be disclosed because, in their view, it offers a mechanism to create a global standard that will generate comparable information and maintain a 'level playing field' for entities.

The discussion paper analyses the proposals from the perspective of whether, and to what extent, capital providers, as the primary user of financial reports, need this information in order to gain an adequate understanding of the future cash flows, and the risks to those future cash flows, that may be generated by an entity engaged in extractive activities. The project team has not reached a view on whether payments to governments should be disclosed on a country-by-country basis. The discussion paper process is intended to highlight the PWYP proposals and, in particular, to assist further study of the cost/benefit implications of the proposals.

A collaborative effort

The discussion paper is the product of collaboration by experts from many organisations. The IASB acknowledges and thanks all those who have contributed to the debate. The project team from the national standard-setters of Australia, Canada, Norway and South Africa engaged with an extensive advisory panel of over 30 people representing entities operating in the minerals or the oil and gas industries, accounting firms, users of financial reports and securities regulators.

Additionally, particular thanks go to the members of the joint CRIRSCO-SPE working group that undertook the comparison study of the CRIRSCO Template with the PRMS to identify the similarities and differences between their classification systems. The extent of comparability between the two systems that the study identified has provided support for the project team to propose a single financial reporting solution for mining and oil and gas extractive activities.

What happens next?

The IASB is seeking comments on the proposals in the discussion paper. The IASB will consider the discussion paper's analysis and proposals and the comments received, in determining whether to add a project to its agenda. This agenda decision will follow the IASB's public consultation later in 2010 of the composition of its technical agenda beyond June 2011.

If the IASB adds a project on extractive activities to its agenda, it will use the discussion paper, and the comments it receives, as the basis for its initial deliberations on the project. At that time, the IASB will decide whether, in the light of the responses received, it would be appropriate to proceed to the development of an exposure draft as the next step in its due process, or whether it is necessary for the IASB to publish its own discussion paper.

Notes

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