

## Extracting value



Issue 6, September 2009

### Focussing on resources industry issues

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### Welcome to Issue 6 of *Extracting Value*, a special edition focussing exclusively on the draft Discussion Paper *Extractive Activities*, recently released 'for information purposes' by the IASB

Whilst ostensibly proposing approaches producing outcomes similar to common industry practice, there are a number of interesting issues and considerations arising from the draft Discussion Paper – such as potentially mandating capitalisation of exploration expenditure and much more information about the fair value of reserves and resources.

This edition of *Extracting value* explores some of these issues, beginning the commercial and pragmatic analysis of the proposals, exploring:

- An overview of the key proposals
- An analysis of some initial reactions and issues
- Discussion of 'where to from here'.

#### Key proposals

There is a lot of diversity in accounting for mining and oil and gas under IFRS. Terminology is inconsistent, treatments vary and the requirements of AASB 6/IFRS 6 *Exploration for and Evaluation of Mineral Resources* permit widely divergent practices on a national and global basis. The draft Discussion Paper, running to nearly 200 pages, seeks to address these concerns.

In summary terms, the Discussion Paper proposes to:

- Introduce mineral reserve and resource definitions based on industry practice
- Eliminate 'phase accounting' – separate accounting for exploration and evaluation, development, production and so on – in favour of one asset, either a 'mineral asset' or 'oil and gas asset'
- Account for mining and oil and gas projects using a 'unit of account' which is effectively the 'area of interest' accounting commonly used in Australia under current standards
- Require measurement based on historical cost, but countenancing the possibility of using another measure such as current value or (more likely) fair value
- Retain a modified impairment approach to assets in the exploration and evaluation stage
- Introduce extensive disclosures, including a form of 'standardised value' for reserves/resources and possibly responding to the 'publish what you pay' lobby.

We'd welcome your feedback on these issues, and the Discussion Paper in general. Please feel free to discuss these with your Deloitte representative, or any of the individuals listed at the back of this publication.

### Initial reactions to the Discussion Paper

The draft Discussion Paper is an important first step on the road to a new IFRS for mining and oil and gas companies. Highlighted below are some of the issues and considerations we've identified to date.

### Will successful efforts and full expensing be banned?

By replacing AASB 6, the proposals would potentially see capitalisation of exploration and evaluation costs become *mandatory*, as part of the overall 'mining asset' or 'oil and gas asset'. The use of successful efforts or full expensing of exploration and evaluation costs would be eliminated in favour of a 'capitalise and test for impairment' approach, with limited triggers for impairment.

The draft Discussion Paper notes the 'area of interest' is the upper limit of the unit of account and a smaller unit of account could be used. It is unclear whether using a smaller unit of account might lead to more expensing where desired and presumably this same smaller unit of account would need to be carried forward to other phases of the operation.

The effects of this proposal may be to increase the carrying amount of mining or oil and gas assets and subsequently increase the costs of production once a project enters production.

### Where's the 'blue sky'?

The fundamental principle in the draft Discussion Paper is that the legal right to explore for, or extract, minerals or oil and gas is the foundation of asset recognition and the 'unit of account'. The upper limit of the unit of account is proposed to be an 'area of interest'.

The interaction between this principle and the concept of 'blue sky' – also referred to as 'future potential', 'mining right', 'mineral rights', 'oil and gas assets', 'value beyond proven and probable reserves' and so on – may be problematic.

'Blue sky' represents the future exploration potential in a prospective area. In a business combination sense, it may represent the aggregate potential of all the exploration and mining rights held by an acquiree – in other words, the possibility that economically recoverable reserves (or further such reserves) may be discovered in an acquiree's exploration portfolio.

It is unclear whether such 'aggregate' potential should be recognised as a separate asset, or subsumed within goodwill. If recognised separately, should it be allocated to individual areas of interest, and on what basis? If subsumed into goodwill, how is the 'individual' blue sky for each area of interest segregated from the 'aggregate' blue sky for the entity as a whole?

These issues have been debated under US-GAAP for a number of years and some guidance has already emerged from the process. The draft Discussion Paper does not deal with this issue and it appears the current uncertainty, and divergent practices, may continue under IFRS.

### Depreciation methodologies may be mandated

The draft Discussion Paper makes some interesting observations regarding depreciation. Acknowledging the various difficulties in how depreciation should be calculated (e.g. which reserves and resources, how to apply units of production, etc), the project team conclude:

- The basis of depreciation for mining and oil and gas assets should not be significantly different from existing IFRSs
- A uniform basis for calculating depreciation expense should apply to both minerals properties and oil and gas properties.

It is unclear whether this may mean, for instance, that *all* entities would be required to use a units of production basis calculated by reference to (say) revenues, or only on the basis of a mandated subset of total resources (perhaps proved, or proved and probable).



In addition, many argue mining and oil and gas assets are distinguishable from the assets of other industries as they are often 'continuously constructed' whilst also being used for production, e.g. expansion of the mine or field, exploration to further delineate and finalise reserves, construction of additional infrastructure to reach reserves, and so on. The draft Discussion Paper does not directly consider whether the depreciable amount of the 'mining asset' or 'oil and gas asset' should include an estimate of *future* capital expenditure to 'match' the reserves/resources used with the amount being depreciated.

Once a ubiquitous practice amongst Australian resources companies, the inclusion of future capex has fallen out of favour under IFRS and is currently not widely adopted. However, this approach does reflect a holistic view of a mining or oil and gas operation, where the development decision is framed from a commercial perspective on the economies of scale of the operation as a whole.

Additionally, the depreciation of 'blue sky' in relation to business combinations in the resources industry will need careful consideration. Should this amount be 'componentised' in the depreciation calculation and carried forward until either additional resources are found, or it is impaired?

#### **Is this *only* about the asset?**

The Discussion Paper focuses on accounting for the 'mining asset' or 'oil and gas asset', including when and how it is recognised and measured. The paper consciously 'avoids issues of general application', such as revenue recognition, inventory accounting, decommissioning and restoration liabilities and joint venture accounting. The Discussion Paper takes the view that in these areas the issues facing the extracting industries 'are not sufficiently different from those in other industries'.

Many standards have exclusions for extractive industries, or permit special treatments (e.g. scope exemptions from AASB 102, AASB 116 and AASB 138 for resources-related activities). It would appear these may be removed if any new IFRS is made as a result of the Discussion Paper.

Additionally, the issues arising in some areas may *not* be adequately dealt with under other Standards, such as:

- the farm-in/farm-out of a project in the exploration stages – because the 'asset' is a bit 'rubbery', the normal 'purchase and sale' principles can be hard to apply and many entities currently use a 'cost accumulation' approach
- the treatment of 'pricing adjustments' for the sale of commodities, where the prices are set by reference to an average market price well after the delivery of product to the customer
- the prohibition on including 'expansory capital expenditure' in value in use models when testing for impairment under AASB 136 – resources projects are unique in that they are producing cash inflows before the asset (mine or field) is finally constructed, which may only occur close to the end of the life of the field or mine. Accordingly, resources companies will continue to test impairment with 'one hand tied behind their back' and regularly not be able to use 'value in use' to support the carrying amounts of their assets, particularly in the earlier stages of the life of a field or mine.

#### **What about activities like geothermal?**

The draft Discussion Paper only deals with extractive activities relating to minerals, oil and natural gas. It explicitly scopes out consideration of similar processes, such as geothermal energy projects and sea water extraction.

Australia has a growing geothermal energy sector, which is likely to continue to expand as the globe responds to the climate change challenge. These entities currently mostly apply AASB 6 when accounting for their activities and this narrowing of scope potentially leaves these entities in 'no man's land', without a directly applicable standard and an uncertain hierarchy response.

### Fair value accounting is not dead yet

The Discussion Paper concludes that historical cost is the best measurement model because it does the ‘least harm’ – it is not a resounding endorsement of the approach. The paper discusses the numerous possible measurement approaches (historical cost, current cost, fair value, etc), and finds, in light of discussions with analysts, users and preparers, that none of the possible measurement approaches is particularly useful.

During the earlier stages of the project, the IASB made it clear to the project team that it should not discount the use of fair value accounting in the Discussion Paper. Some Board members even remarked at that time that ‘unless you recommend fair value accounting, you’re wasting your time’. The IASB has not endorsed the Discussion Paper proposals as yet and the paper itself is not ‘strong’ in its conclusion that historical cost is the right answer.

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## We have been in this boat before, both in Australia and globally, with agricultural assets.

There remains a clear possibility that fair value accounting will emerge as the measurement approach put forward in an exposure draft. Interestingly however, the Discussion Paper also concludes that if the historical cost approach is adopted, the optional use of the ‘revaluation basis’ should be prohibited.



### The disclosures *really* are voluminous

The proposals in the Discussion Paper for disclosures find their genesis in the measurement problem – because no measurement basis emerges as a clear approach, extensive disclosures are proposed to rectify the dilemma. Proposals include:

- Reserves and resources quantities, how they were estimated and the main assumptions used with a sensitivity analysis and reconciliations of changes in reserve quantities – these details would be required by commodity, and further broken down by country or project where material
- A ‘current value measurement’ under various possible options, by major geographical region
- Production revenues by commodity
- Costs (interestingly by phase), disaggregated in the same manner as reserves and including a five-year time series.

The Discussion Paper continues the push towards disclosure overload, although much of the information disclosed would be of key interest to analysts and competitors.

### The ‘publish what you pay’ proposals are political

The Discussion Paper devotes an entire chapter to the ‘Publish What You Pay’ (PWYP) campaign being waged by a coalition of non-governmental organisations. PWYP seeks to help citizens of resource-rich developing countries to hold their governments accountable for the management of revenues from the mineral and oil and gas industries by requiring detailed country-by-country disclosure of amounts paid to government, along with other information which allows users to understand the scale of an entity’s operations in each country.

The PWYP coalition champions a noble, if highly political, cause. It unsuccessfully lobbied the IASB to introduce these sorts of requirements as part of the issue of IFRS 8 *Operating Segments*, which saw the issue referred to the extractive activities project team.

The Discussion Paper remains neutral on the PWYP proposals and instead leaves it open for constituent comment. It would appear this area will become a key issue as the project continues.

### Where to from here?

The *draft* Discussion Paper on *Extractive Activities* is an unusual beast. It's a case of the Clayton's discussion paper, or 'the discussion paper you have when you don't have a discussion paper'.

The Discussion Paper is only in *draft* form and comments are not requested by the IASB at this stage. The conclusions and recommendations have not yet been agreed by the IASB. The Discussion Paper is a 'working draft for information only', will only be issued formally during 2010 and even then only as a *Request for Views*, i.e. without formal IASB 'blessing'.

Unfortunately, the Discussion Paper is an indirect casualty of the global financial crisis. The IASB has brought forward numerous major projects to address critical concerns, such as the rewrite of IAS 39 *Financial Instruments: Recognition and Measurement* and associated projects on derecognition, consolidation and so on. Something had to give, and the extractive activities project is one of them – an easy target one might argue, because the project has not yet been formally added to the IASB's agenda and it's not in the Memorandum of Understanding with the Financial Accounting Standards Board (FASB) of the United States.

So, at the current time, the project somewhat sits in limbo. There is a slight possibility that it might not even make it onto the IASB's agenda and proceed to an ED, although there is a fairly strong expectation that it will. After publication of the *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.

This places the timing for the ED in 2011–2012 and a standard sometime after that, perhaps 2013. With the usual implementation lead time, this could mean the earliest a new standard would be applicable is probably 2014.

The long timeframes involved may suggest that the draft Discussion Paper is not a high priority right now. This is partially true in terms of near term forecasting and planning. However, history has shown that making views known *early* in the life of an IASB project is the most successful strategy for achieving desired outcomes.

Clear and strong comments made when the formal Discussion Paper is released will be important, before a momentum towards a particular approach develops. This is amplified in this case because the unusual circumstances surrounding the draft Discussion Paper mean the IASB has not yet formulated its own views and may decide to propose different approaches on the basis of feedback received on the *Request for Views* – for example, the use of fair value accounting for reserves and resources.

Resources companies should therefore carefully consider the draft Discussion Paper and its possible impacts and be ready to respond when formal comment is requested, or even consider lobbying efforts beforehand if the proposals are particularly contentious.

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