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Sir David Tweedie
Chairman
International Accounting Standards Board
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Email: commentletters@iasb.org

30 July 2010

Dear Sir David,

Re: Discussion Paper DP/2010/1 Extractive Activities

Deloitte Touche Tohmatsu is pleased to comment on the International Accounting Standards Board's Discussion Paper DP/2010/1 Extractive Activities (referred to in this letter as 'DP/2010/1' or the 'Discussion Paper').

We welcome the Board's publication of the Discussion Paper and support the IASB developing authoritative guidance for extractive activities. Consistency in the accounting and disclosure model for these activities is needed and can best be achieved by the Board undertaking a project in this area. While we believe that the Discussion Paper will likely be a useful document for the Board, we have a number of concerns and we offer some recommendations as the Board moves this project forward.

In our view, the use of a historical cost-based model is the most appropriate measurement approach for extractive activities. Historical cost is consistent with existing IFRSs that address other types of activities and it is currently used extensively by users making capital allocation decisions. We agree with the view expressed in the Discussion Paper that the use of a market-based measure is not justifiable on cost-benefit grounds and is not supported by industry participants, analysts and other users of the financial statements.

We agree with the project team's recommendation with respect to the definitions of reserves and resources to be used in any IFRS on extractive activities and the need for common definitions for all extractive activities within the scope of any future IFRS. However, we believe that it is important that the definitions ultimately chosen are accepted by industry and consistent across all jurisdictions to avoid the need for multiple reserve and resource determinations and reconciliations. Therefore, we urge the Board to cooperate closely with national standard-setters, securities markets regulators and industry bodies to ensure acceptance and consistency in definitions.

In our view, the Discussion Paper does not articulate clearly the nature of the asset arising from extractive activities. Further research is required to determine the nature of the asset(s) and the justification for

capitalising subsequent expenditures within the context of the Conceptual Framework. We also believe that further research is necessary to develop an appropriate impairment model for such assets.

We agree with the overall disclosure objectives proposed by the Discussion Paper, provided that those objectives do not lead to a requirement to disclose fair values. However, we have significant concerns about the nature and extent of the disclosures proposed, in particular the level of disaggregation required, the need for sensitivity analyses and the cost of preparing the proposed disclosures.

Our detailed responses to the invitation to comment questions are included in Appendix A to this letter. Additional matters we recommend the IASB consider in relation to the Extractive Activities project are included in Appendix B to this letter.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884.

Sincerely,

Veronica Poole
Global IFRS Leader – Technical

Appendix A – responses to specific questions

Question 1 – Scope of extractive activities

In Chapter 1 the project team proposes that the scope of an extractive activities IFRS should include only upstream activities for minerals, oil and natural gas. Do you agree? Are there other similar activities that should also fall within the scope of an IFRS for extractive activities? If so, please explain what other activities should be included within its scope and why.

We agree with limiting the scope of the project to upstream activities of entities involved in extractive activities.

However, we believe the IASB should:

- consider which activities are considered 'extractive activities' within the scope of this project; and
- address comprehensively the common issues encountered by entities when accounting for upstream activities.

Nature of 'extractive activities'

We recommend the Board consider which activities are regarded as 'extractive activities' within the scope of this project. For example, consideration should be given to including geothermal and similar activities within the scope of the project as the business and commercial risks and the methods of operation in geothermal projects are in many ways very similar to extractive activities. Excluding similar types of activities from the scope of any final Standard may result in entities using the 'hierarchy' in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which in turn could lead to entities applying any final IFRS even though their activities are technically outside its scope. Accordingly, we recommend that the Board include geothermal and similar activities within the scope of this project, or at least specify which parts of any final IFRS can be applied by analogy.

We also suggest that the scope paragraph be clarified through examples describing the products that would fall within upstream extractive activities. Appendix A to the Discussion Paper describes the stages and components of extractive activities (i.e., prospecting, exploration, evaluation, development and production), with detailed descriptions of each component. We suggest expanding these descriptions within Appendix A to include examples of products mined/extracted (e.g., uranium, gold, potash, etc) for which the extractive process would fall within the descriptions in Appendix A and would therefore be within the scope of the project. It will be particularly important to consider activities such as oil sand and shale gas as it is unclear whether such activities would be within the scope of the Discussion Paper.

In addition, many of the accounting issues arising from exploration and evaluation activities may be seen as similar to those issues faced by industries involved in research and development activities. We believe that research and development activities can be sufficiently differentiated from exploration and evaluation activities but the Discussion Paper does not adequately address this distinction. We recommend that this area is explored more comprehensively as the Board moves forward on the project.

Other issues arising from upstream activities

In addition to the recognition and measurement of the core asset arising from extractive activities, there are a number of unique issues encountered by entities when accounting for upstream activities. These issues are either not addressed in existing IFRSs, covered by scope exemptions, or the accounting outcome produced by applying IFRSs is counter-intuitive. A summary of these issues is provided in Appendix B and we strongly recommend that the IASB includes consideration of these, and similar, issues as part of this project.

Question 2 – Approach

Also in Chapter 1, the project team proposes that there should be a single accounting and disclosure model that applies to extractive activities in both the minerals industry and the oil and gas industry. Do you agree? If not, what requirements should be different for each industry and what is your justification for differentiating between the two industries?

We agree with this proposal. We see no reason for the same accounting requirements not to apply to both industries, as long as any final IFRS is conceptually sound and is operational for all entities engaged in extractive activities.

In addition, some industries exhibit elements of both industries, such as oil sands operations. If separate requirements were to be developed for mining and oil and gas industries, applying the requirements in these 'hybrid' industries could be problematic.

Question 3 – Definitions of minerals and oil and gas reserves and resources

In Chapter 2 the project team proposes that the mineral reserve and resource definitions established by the Committee for Mineral Reserves International Reporting Standards and the oil and gas reserve and resource definitions established by the Society of Petroleum Engineers (in conjunction with other industry bodies) should be used in an IFRS for extractive activities. Do you agree? If not, how should minerals or oil and gas reserves and resources be defined for an IFRS?

We agree with the project team's recommendation with respect to the definitions of reserves and resources to be used in any IFRS on extractive activities and the need for common definitions for all extractive activities within the scope of any future IFRS. We support the use of the definitions established by the Society of Petroleum Engineers and CRIRSCO, as these are global industry definitions which are widely used and well understood by the industry and users of this information. However, we have some concerns about the approach, as discussed below.

It is unusual for the IASB to rely on definitions developed by a third party when developing an IFRS. Whilst we understand the need for industry expertise in developing the definitions, this approach will require the IASB to develop and/or maintain appropriate monitoring and liaison activities with the relevant definition setters to ensure that:

- appropriate due diligence procedures are in place within the relevant organisations which are consistent with the IASB's own procedures; and
- future changes in the definitions are appropriate for continued use in IFRSs.

In addition, the IASB may need to develop contingency plans for circumstances where industry definitions are no longer appropriate for accounting purposes.

The Discussion Paper also notes other possible candidates as the basis for the definitions. It is important that the definitions chosen are accepted by industry and consistent across all jurisdictions to avoid the need for multiple reserve and resource determinations and reconciliations. Therefore, we strongly recommend that the IASB work with both the Financial Accounting Standards Board (FASB) and the International Organization of Securities Commissions (IOSCO) on this project to ensure that:

- the reserve and resource definitions, accounting methodologies and disclosures are converged between IFRSs and US GAAP;
- any proposed definitions are accepted by industry and the users of the information; and
- regulators apply the same reserve and resource definitions to avoid the need for multiple and costly reserve and resource calculations under differing frameworks.

This need for convergence extends to all aspects of any proposed recognition, measurement, presentation and disclosure framework for extractive activities. Accordingly, we believe this project should proceed as a joint project with the FASB.

Question 4 – Minerals or oil and gas asset recognition model—recognition

In Chapter 3 the project team proposes that legal rights, such as exploration rights or extraction rights, should form the basis of an asset referred to as a 'minerals or oil and gas property'. The property is recognised when the legal rights are acquired. Information obtained from subsequent exploration and evaluation activities and development works undertaken to access the minerals or oil and gas deposit would each be treated as enhancements of the legal rights.

Do you agree with this analysis for the recognition of a minerals or oil and gas property? If not, what assets should be recognised and when should they be recognised initially?

Whilst we appreciate the arguments used in the Discussion Paper, we believe further research is required to determine the nature of the asset(s) arising from extractive activities and the justification for capitalising subsequent expenditures within the context of the Conceptual Framework. We also believe that further research is necessary to develop an appropriate impairment model for such assets.

It is reasonable that the costs of acquiring legal rights to explore (either from government or from another party) could meet the definition of an asset and hence should be capitalised. Similarly, property, plant and equipment acquired as part of, and used in, the extractive activities process should be capitalised in accordance with IAS 16.

The treatment of subsequent expenditure is conceptually more difficult. Some consider exploration and evaluation expenditures to be enhancing the legal right, whilst others regard such expenditures as relating to the possible reserve contained within the property over which legal rights are held. Regardless of the view held, the capitalisation of subsequent expenditure would depend on an assessment of whether the particular expenditure provides information that indicates, or indicates an increased likelihood of, an economically recoverable reserve and thus results in an enhancement of the asset. However, we acknowledge that the information necessary to determine whether capitalisation is appropriate may not be available at the time the expenditure is incurred.

An alternative approach to addressing this issue would be to recognise a separate 'work in progress' asset whilst information is gathered (noting that the information gathering is usually conducted in the context of legal rights which give control over any benefits). Upon completion of the information gathering, the 'work in progress' amount would either be included as part of the extractive activities asset or derecognised depending on whether the expenditure results in an enhancement of the asset.

We believe that the guidance in any final Standard should be in line with the IASB's Conceptual Framework project. In addition, we believe it is important to compare and contrast the differences between 'exploration and evaluation' and 'research and development' under IAS 38 *Intangible Assets*, as noted in our response to Question 1.

Question 5 – Minerals or oil and gas asset recognition model—unit of account selection

Chapter 3 also explains that selecting the unit of account for a minerals or oil and gas property involves identifying the geographical boundaries of the unit of account and the items that should be combined with other items and recognised as a single asset.

The project team's view is that the geographical boundary of the unit of account would be defined initially on the basis of the exploration rights held. As exploration, evaluation and development activities take place, the unit of account would contract progressively 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. The project team's view is that the components approach in IAS 16 *Property, Plant and Equipment* would apply to determine the items that should be accounted for as a single asset.

Do you agree with this being the basis for selecting the unit of account of a minerals or oil and gas property? If not, what should be the unit of account and why?

We broadly agree with the proposal that the unit of account should be based on the physical boundaries of the asset, but we have some concerns about the potential for diversity developing that we discuss below. It is logical that the initial 'upper limit' of the unit of account is the whole of the right obtained. We believe it is

reflective of the level at which transactions occur between market participants and therefore reflects commercial realities.

We believe that some measure of flexibility is necessary from a practical perspective to reflect how operations are managed, e.g. some mining operations may have two mines feeding one plant. However, a balance between flexibility and consistency is important to reduce the potential for the proposals to lead to diversity in practice. For example:

- An entity could designate the unit of account in exploration activities as individual drill holes or wells, whereas another could designate the legal right (or contiguous legal rights) as the unit of account. This could lead to the first entity expensing certain costs if an individual hole was dry, whereas the second entity might capitalise all costs since the legal right overall is enhanced.
- Some entities may chose to use a 'whole of mine or field' approach to amortisation/depletion, whereas another may chose a 'specific identification' approach at a detailed, well-by-well, bench-by-bench or stope-by-stope level. The impact of these approaches on the costs of production in particular periods can be significant.

We recommend that the Board provides examples of how the unit of account guidance should be applied. In developing the examples, we recommend that the Board consults with the industry and conducts field testing.

Question 6 – Minerals or oil and gas asset measurement model

Chapter 4 identifies current value (such as fair value) and historical cost as potential measurement bases for minerals and oil and gas properties. The research found that, in general, users think that measuring these assets at either historical cost or current value would provide only limited relevant information. The project team's view is that these assets should be measured at historical cost but that detailed disclosure about the entity's minerals or oil and gas properties should be provided to enhance the relevance of the financial statements.

In your view, what measurement basis should be used for minerals and oil and gas properties and why? This could include measurement bases that were not considered in the discussion paper. In your response, please explain how this measurement basis would satisfy the qualitative characteristics of useful financial information.

Overall, we agree with the project team's proposal to measure minerals or oil and gas properties at historical cost, given:

- the costs necessary to calculate fair value outweigh the benefits;
- the subjectivity associated with fair value measurement assumptions;
- the volatility that would arise from fair value measurement; and
- historical cost is currently used in making investment decisions.

Our comments on the discussion of the possible measurement approaches follow.

Historical cost

The Discussion Paper provides a number of reasons why historical cost does ***not*** provide useful information to the users of the financial statements. There is currently limited justification for using historical cost; instead the Discussion Paper recommends it on the basis of 'causing least harm'. We believe any final Standard on extractive activities should articulate better why historical cost is the best measurement basis.

Historical cost measurement benefits from being reliable, representing the amount actually expended in exploring for, and developing, a mining operation or an oil and gas field. As such, it provides an important measure of performance of an entity and its success in finding and developing reserves.

The application of historical cost principles to extractive activities differs from other industries in that there is no clear correlation between the amounts expended and likely or possible returns. Cumulative expenditure on exploration and evaluation will depend on the sequence of activities in exploring, as well as the location, nature and depth of any mineralisation that may exist. Many other factors will also impact the amount expended such as weather, licence conditions and agreements with other parties. The return received from

development will depend upon geological, geographical, cost, regulatory and other factors. The predictable return on investment often present in other industries rarely exists in extractive activities. Accordingly, historical cost rarely correlates with expected returns in a way it might do in other industries.

Therefore, it is important that the Board adequately considers the effects of the measurement requirements in any final Standard on the performance measures reported by mining and oil and gas entities. The Board should consider the need for additional research to determine if disclosure, separate presentation, or other information is necessary to ensure comparability of financial performance measures reported by mining and oil and gas entities to eliminate variability, particularly arising from the pre-production phases of an extractives project.

For instance, mandating capitalisation of all exploration and evaluation expenditure will affect subsequent costs of production in the event the exploration is successful. Therefore, the cost of production will in effect include a measure of success of the exploration programme undertaken. In reality, this may include the costs related to 'unsuccessful' exploration activities within the boundaries of the unit of account. Consideration should be given as to whether this impact should be treated separately in some manner, if justified on cost benefit grounds.

Fair value

We agree with the conclusion in the Discussion Paper that the costs of adopting a fair value basis may exceed the costs. (Our comments on fair value in relation to the proposed disclosures are detailed in our responses to Questions 8 and 9).

Determining a fair value can be problematic as is evidenced by the difficulties that mining and oil and gas companies currently face in applying the fair value measurement basis required by IFRS 3 *Business Combinations* in relation to acquisitions of resource operations. Although some guidance on this matter exists under US GAAP, the predominant current practice in relation to business combinations outside of US GAAP is to report little, if any, goodwill. The pragmatic justification for this approach often relies on a combination of the following arguments.

- It is difficult to identify and measure reliably the identifiable assets and goodwill arising in a business combination in the extractive industries.
- The future economic benefit is not separable from the existing reserves and resources and the potential of around mine or field exploration and other possible future exploration potential.
- The recognition of goodwill in a business combination in extractive activities results in an asset that is not amortised and ultimately impaired as the project nears completion, distorting financial performance.
- There is a lack of market transactions that could be used as a basis in determining a fair value for individual extractive assets acquired in a business combination, i.e. such assets are either acquired as part of the overall business (which may be the project as a whole) or transactions involving early-stage projects are often structured as risk-sharing arrangements rather than exchanges at fair value. Furthermore, extractive assets are often not comparable due to a variety of factors, including differences in geology, reserves/resource estimations and location.

Further comments on the accounting for business combinations in extractive activities are included in Appendix B.

The difficulty in attributing a single fair value reflects the wide ranges of values potential purchasers may place on the commercial uncertainty inherent in extractive activity projects and assets. Accordingly, we do not believe fair value is an appropriate mandatory measurement basis for extractive assets.

In the event the Board decides to adopt a fair value measurement basis in any final IFRS for extractive activities, cost effective and internationally supported valuation techniques will be required. In this case, the Board should also consider working with the International Valuation Standards Committee (IVSC) and other appropriate bodies to explore the efficacy of measurement standards based on fair value and to address some of the issues currently encountered in applying the fair value concept in business combinations.

Other measures

Finally, we do not support the use of any type of 'standardised measure' as the primary measurement basis (our comments on the disclosure of this information are outlined in our responses to Questions 8 and 9 below).

Question 7 – Testing exploration properties for impairment

Chapter 4 also considers various alternatives for testing exploration properties for impairment. The project team's view is that exploration properties should not be tested for impairment in accordance with IAS 36 *Impairment of Assets*. Instead, the project team recommends that an exploration property should be written down to its recoverable amount in those cases where management has enough information to make this determination. Because this information is not likely to be available for most exploration properties while exploration and evaluation activities are continuing, the project team recommends that, for those exploration properties, management should:

(a) write down an exploration property only when, in its judgement, there is a high likelihood that the carrying amount will not be recoverable in full; and

(b) apply a separate set of indicators to assess whether its exploration properties can continue to be recognised as assets.

Do you agree with the project team's recommendations on impairment? If not, what type of impairment test do you think should apply to exploration properties?

Whilst we understand the rationale expressed in the Discussion Paper in relation to impairment testing, we believe the proposed approach requires further research and refinement.

We agree that the application of the impairment test in IAS 36 *Impairment of Assets* is problematic in relation to projects in the exploration and evaluation phases. However, the proposal that an impairment loss could only possibly arise when there is a 'high likelihood' of not recovering the asset in full may be considered to be inconsistent with the Framework and the impairment testing requirements of other standards.

As noted in our response to Question 4 above, one alternative approach would be to recognise a separate 'work in progress' asset whilst information is gathered (noting that the information gathering is usually conducted in the context of legal rights which give control over any benefits). Upon completion of the information gathering, the 'work in progress' amount would either be included as part of the extractive activities asset or derecognised depending on whether the expenditure results in an enhancement of the asset. Amounts held as 'work in progress' could be subject to a modified impairment regime, or none at all.

Another alternative could be to require an impairment test based on whether information is available to determine and measure the recoverable amount reliably. This may be a more appropriate criterion than the 'high likelihood' test proposed in the Discussion Paper.

In the event the proposals are retained or not substantively modified, we recommend that the Board considers how transactions involving exploration and evaluation interests are accounted for in general terms, in particular the accounting for disposals of partial interests in exploration and evaluation assets (through 'farm ins'/'farm outs' etc). It may be seen as inappropriate to carry forward exploration and evaluation costs as an asset without an impairment test and then to recognise a gain or loss on a partial disposal based on the proportionate interest disposed of. The Board should consider the common practice of reducing the carrying amount of any exploration and evaluation asset by the proceeds received, effectively as a 'recovery of cost', without any gain or loss being recognised. This would help reduce the risk of a possible unknown impairment in the underlying asset. Alternatively, the partial sale of an interest could trigger a requirement to test for impairment. This matter is further discussed in Appendix B.

Question 8 – Disclosure objectives

In Chapter 5 the project team proposes that the disclosure objectives for extractive activities are to enable users of financial reports to evaluate:

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

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

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

Do you agree with those objectives for disclosure? If not, what should be the disclosure objectives for an IFRS for extractive activities and why?

We agree with the overall disclosure objectives proposed by the Discussion Paper, provided that those objectives do not lead to a requirement to disclose fair values. In addition, we have the following comments on the proposed disclosure objectives.

- We believe that disclosure objective (a) should focus on disclosure about the amounts *recognised* in the financial statements, i.e. the assets measured on the historical cost basis. Any disclosures required should provide additional information about the amounts determined using this measurement basis if justified on a cost-benefit basis. If this was the intention of the project team, this should be made clear.
- It may be appropriate to provide information that enables users to evaluate the value attributable to an entity's minerals or oil and gas properties, but without necessarily requiring the disclosure of the fair value of those assets. We believe that any requirement for this type of information is consistent with disclosure objective (c).

Verification and audit of information

The Discussion Paper acknowledges the difficulty in auditing some of the disclosures proposed and suggests that this information may be presented outside of the audited financial statements.

We share the concerns expressed in the Discussion Paper regarding the ability to audit some of the information proposed. We also note that this issue extends beyond the ability to audit to the governing body and other management of the entity. Disclosure of such information is often qualified due to the uncertainties involved.

Given the requirement to make an explicit statement of compliance with IFRSs, the proposed disclosures may result in that statement of compliance being qualified by both management and auditors regardless of whether such information can be presented outside the financial statements. This could undermine the objectives of IFRSs. Accordingly, we believe the Board should consider carefully how this type of information could be provided by those involved in extractive activities taking into consideration the potential risk of qualification by management and auditors.

Question 9 – Types of disclosure that would meet the disclosure objectives

Also in Chapter 5, the project team proposes that the types of information that should be disclosed include:

(a) quantities of proved reserves and proved plus probable reserves, with the disclosure of reserve quantities presented separately by commodity and by material geographical areas;

(b) the main assumptions used in estimating reserves quantities, and a sensitivity analysis;

(c) a reconciliation of changes in the estimate of reserves quantities from year to year;

(d) a current value measurement that corresponds to reserves quantities disclosed with a reconciliation of changes in the current value measurement from year to year;

(e) separate identification of production revenues by commodity; and

(f) separate identification of the exploration, development and production cash flows for the current period and as a time series over a defined period (such as five years).

Would disclosure of this information be relevant and sufficient for users? Are there any other types of information that should be disclosed? Should this information be required to be disclosed as part of a complete set of financial statements?

We agree that specific disclosures should be required for entities engaged in extractive activities. However, we believe that some of the proposed disclosure requirements are onerous, unnecessary, or covered by existing or proposed disclosure requirements in other standards. In addition to the cost of preparing the proposed disclosures, our main concerns about the proposed disclosures include the level of disaggregation required, the need for sensitivity analyses and the requirement for valued based measures.

We believe the required disclosures should be simplified and modified to provide the key *financial* information required by users of financial statements, provided that information is not onerous to prepare and is useful to users of financial statements in general. It is important that a cost-benefit assessment is made before any additional disclosures are required. In addition, we strongly recommend that the IASB seeks a level of convergence between its own proposed disclosures and those of the US Securities Exchange Commission (SEC).

Sensitivity analysis of reserves

The determination of reserves (and resources) information is a complex process involving numerous variables, assumptions and processes. In practice, determining reserves is very dependent on long-term prices for the contained commodity as it determines the 'cut off' between economic and uneconomic resources. The calculation process can therefore be extremely laborious and in some sectors it can take many months to reflect new variables, particularly long term commodity prices. Furthermore, the outcomes from further exploration cannot be determined in advance even though it has a direct impact on reported reserves.

Because of these factors, we believe the sensitivity analysis disclosure cannot be justified due to cost-benefit concerns and also because the information may not be useful or relevant to the users of the financial statements because of the uncertainties involved. We therefore recommend that the Board relies on the existing disclosure requirements relating to significant judgements and sources of estimation of uncertainty already contained in IAS 1 *Presentation of Financial Statements*.

Current value measurement

In addition to our comments relating to fair value in Question 6 above, we question the relevance of the proposed current value measurement disclosures for the following reasons.

- Requiring current value disclosures contradicts the Discussion Paper's rationale for adopting a historical cost measurement basis that fair values cannot be readily or reliably determined.
- The dictated standardised measure produces information the use of which is not widespread and, in addition, it is not justifiable on cost benefit grounds.
- The current value measure is proposed for reserves only and does not include any consideration of additional resources on which industry participants may place some value in market transactions.

In the event the Board decides to proceed with these proposed disclosures, we believe the Board should undertake more wide-ranging research to determine if the disclosure is actually useful to users of the financial statements. If considered useful, the Board should carry out field testing and clearly explain in any final Standard how the benefits of providing such information exceed the costs necessary to produce that information.

Revenues and costs

We also have concerns about the proposed disclosures around revenues and costs for the following reasons.

- The disclosures relate to areas not explicitly considered in the Discussion Paper and it is unclear why these disclosures should be mandated in an IFRS dealing only with assets arising from extractive activities.
- The disclosures proposed are covered by existing IFRSs or projects (including financial statement presentation and revenue recognition) and should not be overridden in this project.
- The disclosure and usefulness of information by 'phases' is questionable in light of the Discussion Paper rejecting this as the basis for recognition and measurement.

- The disclosure proposed may be inconsistent with information required by IFRS 8 *Operating Segments* and therefore may be confusing or potentially misleading for users.
- The usefulness of historical time series information is questionable. This sort of time-series information is rarely required under IFRSs and we see no compelling reason to require such additional disclosure for entities engaged in extractive activities.

Question 10 – Publish What You Pay disclosure proposals

Chapter 6 discusses the disclosure proposals put forward by the Publish What You Pay coalition of non-governmental organisations. The project team's research found 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. It also found that providing information on some categories of payments to governments might be difficult (and costly) for some entities, depending on the type of payment and their internal information systems.

In your view, is a requirement to disclose, in the notes to the financial statements, the payments made by an entity to governments on a country-by-country basis justifiable on cost-benefit grounds? In your response, please identify the benefits and the costs associated with the disclosure of payments to governments on a country-by-country basis.

We do not agree with this proposal.

We believe these proposals extend the use of IFRS financial statements beyond its traditional use by capital providers to a wider group of stakeholders.

Before the IASB pursues such objectives, we believe it should first develop an appropriate framework for such disclosures – possibly a social reporting or sustainability reporting framework.

Furthermore, we do not believe the extractive activities project is the appropriate place to consider these issues as the effects of the proposals would impose requirements on a particular industry sector without considering whether other entities or industries should also make such disclosures. This may open the Board to criticism.

Appendix B – Additional issues recommended for consideration in an Extractive Activities project

Background

There are a number of important industry-specific issues being faced by entities engaged in extractive activities.

Whilst some of these issues might be considered 'interpretative', the majority of the issues listed in this Appendix are matters where IFRSs do not provide guidance, or the existing guidance cannot reasonably be applied to produce financial information that is relevant and reliable.

Impairment testing

There are numerous difficulties in applying the impairment testing requirements under IAS 36 *Impairment of Assets*.

The 'phased' nature of extractive activities means that many, or all, phases of an extractives operation – exploration, evaluation, development, production and decommissioning - can occur at the same time. Production will routinely commence while development continues. Exploration and evaluation designed to identify and expand reserves (or to 'prove up' reserves) will continue. Major expansionary expenditure is often deferred to maximise cash flows (e.g., extending a decline or shaft, up-scaling plant capacity, expanding well heads), only being completed as required throughout the life of the operation.

However, as the investment decision is made in the context of the project as a whole:

- the economic and commercial decision to proceed with a development considers future capital expenditure and the returns from that capital expenditure;
- the design of the mining or oil and gas operation seeks to maximise returns from the operation overall and does not explicitly consider individual 'expansions' as production continues, e.g., in a mining operation, ore may be uneconomic on its own but 'blended' with other ore to achieve optimal ore grades for processing, or otherwise uneconomic ore in an underground mine, may be mined in gaining access to high grade ore; and
- the initial infrastructure is constructed in view of the final scale of the operation, and therefore it may not be supported by cash flows expected from accessible reserves which can currently be extracted.

The outcome of the above is an asset which continues to be built even as it is being used (and therefore is "ready for use"). IAS 36.44 prohibits the inclusion of future cash flows arising from improving or enhancing an asset's performance when determining the 'value in use'. In practice, there is uncertainty as to whether only the cash flows from currently accessible reserves can be included in the calculation of value in use for extractive assets, potentially leading to an impairment loss, or whether future capital expenditure and cash flows from reserves accessible as a result of that expenditure can be included in the value in use calculation by reference to IAS 36.49.

As a result, many entities involved in extractive activities choose to determine recoverable amount of the cash-generating unit by reference to the fair value less costs to sell. In some cases, this may lead to additional efforts and costs in complying with IAS 36, including the use of valuation and other experts.

We believe the above impairment issues are important and recommend that the IASB considers them further as part of its extractive activities project.

Recognition and measurements of resource-related assets in business combinations

Issues in applying current requirements

As noted in our response to Question 6 in Appendix A, mining and oil and gas companies currently face numerous difficulties in applying the fair value measurement basis required by IFRS 3 *Business Combinations* in relation to acquired resource operations. The key issue is how to identify and measure reliably the identifiable assets arising from extractive activities. The Discussion Paper itself acknowledges the practicality and subjectivity concerns about the use of fair values in impairment testing and accounting for business combinations.

It is common practice for many mining and oil and gas companies to recognise little or no goodwill, often because of:

- the practicality issues and the subjective nature of determining fair values of resource-related assets, particularly the inherent uncertainties in relation to exploration, evaluation and 'future potential' where market transactions are more in the form of transfers of risk rather than exchanges of interests based on a 'fair value', i.e. there is little or no market-based evidence on which to base a fair value assessment; and/or
- any future economic benefit is not separable from the existing reserves and resources and the potential of around mine or field exploration and other possible future exploration potential, i.e. there is little that can be identified as arising from other assets acquired in a business combination that are not already individually identified and separately recognised.

Instead, many recognise an additional asset, commonly referred to as 'future potential', 'blue sky', 'mining right', 'mineral rights', 'oil and gas assets', 'value beyond proven and probable reserves' and so on. This asset represents the future exploration potential in a prospective area or it may represent the aggregate potential of all the exploration and mining rights held by an acquiree (such that, on average over all such interests, it may be relatively likely that an economically recoverable resource exists or that existing known resources may be extended).

We therefore recommend that the IASB consider the accounting for business combination in the extractive industries as part of its project, and in particular:

- the appropriateness of a 'future potential' asset and its differentiation from other assets such as reserves and resources and goodwill; and
- the appropriate measurement principle for any 'future potential' asset, i.e. how the fair value principle can be applied objectively in the absence of any reliable measurement other than an upper limit of the amount paid for the acquiree as a whole.

Interaction with proposals in the Discussion Paper

The fundamental principle in the DP 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 effectively proposed to be a single mine or field in many cases.

The interaction between this principle and the concept of 'future potential' is problematic.

In the event the project proceeds in line with the recommendations in the Discussion Paper, we recommend that the IASB considers the following issues.

- How does the 'legal rights' concept interact with the 'future potential' asset, i.e. is 'future potential' included in the measurement of legal rights?
- Should 'aggregate' future potential be recognised as a separate asset, subsumed within goodwill, or allocated to existing projects and/or cash-generating units? If separately recognised, how should 'future potential' identified with particular projects be distinguished from overall 'future potential'?
- How should the depreciation and impairment requirements be applied to any 'future potential' asset?

Depreciation, depletion and amortisation

Some of the assets currently recognised as a result of extractive activities are currently scoped out of IAS 16 and IAS 38. This has lead to diversity in practice on how depreciation and amortisation (sometimes referred to as 'depletion') is calculated.

As noted above, many mining or oil and gas operations continue to be developed (often at significant cost) in the period after production has begun. In addition, significant evaluation and 'proving up' expenditure may be incurred in order to identify reserves as the extractive activity continues. Both these factors have the effect of increasing the depreciable amount of assets as the mine life proceeds.

Furthermore, there is diversity in how the depreciable amount is amortised. Some entities use a measure of reserves, others a measure of resources and others a mixture of both (e.g. reserves plus 'high-confidence' resources). In some cases, reserves are not proven at all, e.g. large scale coal operations, underground mines 'open at depth' (i.e. the resource extends significantly below the depth to which drilling and other exploratory activities have currently been undertaken).

As a result of these factors, the depreciation calculations for extractives projects can be complex. The use of resources as a depreciation base has the effect of deferring depreciation expense towards the end of the life of the mine (with capital expenditure incurred later in the life of the operation and hence amortised over a shorter period even though the capital expenditure is planned upfront, taking the eventual scale of the project into account). The use of resources effectively understates the cost of production in earlier periods as it may not allow for future capital expenditure necessary to exploit the resources over which the assets are being depreciated.

Some entities currently adopt a 'hybrid' depreciation calculation that is based on quantifiable resources, but include in the depreciable amount an estimate of *future* capital expenditure required to exploit those resources. This results in higher costs of earlier production as they notionally include depreciation for later expenditure. Those applying this approach argue it better reflects the commercial rationale for deciding to develop a particular mine or oil and gas operation.

In the event the project is added to the IASB's agenda, we strongly recommend that the IASB considers how entities engaged in extractive activities should depreciate their assets. We believe the unit of production basis is the preferable approach.

We also note that this issue has consequences for the current deliberations of the IFRS Interpretations Committee (IFRIC) on the accounting for stripping costs in the production phase of a mine.

Joint ventures and sharing of risks

Given the inherent uncertainty surrounding mining and oil and gas operations, a number of 'risk sharing' mechanisms have developed. These mechanisms involve the possible transfer of an interest in an extractives project in exchange for agreed activities. The amount an entity may be willing to pay or receive in these exchanges will usually bear little resemblance to their fair values. Instead, the focus is on the sharing of risks and returns. Because of this lack of a fair value, unique accounting issues arise.

Example: Farm-in, farm-out and similar transactions

A "farm-in" is an arrangement whereby an entity gains an interest in a mining or oil and gas property in exchange for spending a particular sum of money or otherwise contributing cash or other assets. The entity which is gaining an interest ('farmee') is said to be "farming in" and the entity reducing its interest (the 'farmor') is said to be "farming out". A farm-in arrangement generally results in the formation or extension of a joint venture in the form of a jointly controlled asset, i.e. they are unincorporated and involve the farmor acquiring an undivided or similar interest in the underlying assets that are subject of the arrangement.

Farm-in/farm-out transactions commonly relate to a farmor's interest in an exploration interest, or sometimes a development or later stage project. The use of farm-out arrangements permits the farmor to spread risk and finance obligations, particularly early in a project's life when alternative means of funding may be difficult to source or the entity has a number of competing projects. Equally, it is common for the farmee to have a right to withdraw from its commitments under the farm-in arrangement, or to receive a variable interest in the project depending upon the amount of expenditure undertaken. In other cases, the farmor's interest may optionally revert to a form of royalty in production from the mineral interest.

The issue of how to account for farm-ins and farm-outs under IFRS is an area of considerable uncertainty. However, the accounting adopted will depend on the substance of the arrangement and the nature of the underlying assets that are being farmed in/farmed out.

As farm-in/farm-out arrangements commonly arise during the exploration and evaluation phase of extractive activity operations, the share of any assets recognised will commonly be accounted for under IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

The accounting for a farm-in/farm-out transaction currently depends upon:

- the entity's accounting policy for exploration and evaluation expenditure chosen in applying IFRS 6; and
- the entity's characterisation of the nature of the farm-in/farm-out transaction.

'Cost accumulation' approach

In some jurisdictions, it is common practice to adopt a 'capitalisation approach' for exploration and evaluation expenditures. Under this approach, an asset is recognised for exploration and evaluation expenditures, even though those expenditures may not have reached a stage at the reporting date which permits a reasonable assessment of the existence or otherwise of economically recoverable reserves.

Because of this 'capitalise if unsure' approach, the exploration and evaluation asset is viewed as a cost accumulation of all expenditures in relation to the mineral right. If the entity then farms-out an interest in the overall area of interest, the following approaches are commonly adopted.

- If cash is received as a result of the farm-out arrangement, the amounts received are used to reduce the asset as it can be seen as a 'recovery of cost'.
- If cash is not received (such as a 'free carry' arrangement for a period of time or for an agreed amount), often no entries are made and the accumulated costs are carried forward as the cost of the entity's interest.
- In some cases, the asset may be tested for impairment if the carrying amount of the asset is higher than the implied value of the farm-out arrangement, i.e. the arrangement is considered to trigger the modified impairment indicator approach dictated by IFRS 6 – although under a pure 'cost accumulation' approach this is not always followed as long as the other requirements of IFRS 6 are met, i.e. none of the modified indicators of impairment are triggered.

Similarly, the entity farming-in to the area of interest might also adopt a 'cost accumulation' approach and recognise an exploration and evaluation asset as the amounts are spent, rather than as an upfront purchase transaction with an associated liability.

This approach is often justified by reference to the requirements of IFRS 6 and the optionality implied in the farm-in arrangement, i.e. most of these arrangements permit the entity farming-in to choose not to expend the full committed amount and thereby relinquish its interest in the tenement.

Many entities involved in the extractive industries strongly prefer a 'cost recovery/ accumulation' approach rather than a 'sale and purchase' approach with farm-ins and farm-outs over exploration and evaluation interests. They argue that the asset is uncertain and that under the 'cost accumulation' approach it would be misleading to show a gain or loss as a result of a farm-out arrangement when the arrangement is in substance a means of sharing costs and spreading risk.

'Sale and purchase' approach

Under this approach, a farm-in/farm-out arrangement is considered a sale of an interest in the asset (or joint venture) by the farmor to the farmee in exchange for a deferred payment over a period of time, being the 'free carried' interest in the asset. Any accumulated costs recognised as an asset by the farmor are treated as having been partially disposed of to the farmee and a receivable is recognised for the future contributions to be made by the farmee (including the impact of discounting where material), with any difference between the two being recognised in profit or loss.

Farm-ins involving other assets

The accounting policy choices are less certain when the assets subject to the farm-in/farm-out arrangement do not fall within the scope of IFRS 6. Although extractive activities are scoped out of many standards to varying degrees (such as IAS 2, IAS 16 and IAS 38), there remains uncertainty about the appropriate accounting standard to follow, either directly or by analogy.

An example of the difficulties encountered in making an accounting policy assessment is the 'optionality' sometimes involved in farm-in/farm-out arrangements. Under these arrangements, the farmor may not obtain any legal rights to the asset(s) being farmed-out until such time as a particular level of expenditure has been met, or alternatively, the level of interest in the final joint venture arrangement may depend on how much expenditure is ultimately made. The farmor is unable to force the farmee to expend the agreed amounts. This provides the farmee with a means of mitigating downside risks through an option to avoid further expenditure, particularly where exploration effort has not yielded satisfactory results.

It is unclear whether these types of arrangements should be characterised as an executory contract, a form of financial instrument (a put or call option), a form of vendor warranty, or as a condition of sale that creates a barrier to revenue recognition by the farmor under IAS 18.14. Other approaches and characterisations may also be possible.

The terms of these types of contracts result from the negotiation process between the parties and therefore they vary widely in substance and form.

We strongly recommend that the IASB considers accounting for these types of arrangements within the scope of any extractive activities project. We believe the unique 'risk sharing' nature of these arrangements in extractive activities (without reference to fair value as it is effectively indeterminable in many cases) justifies consideration in this project.

This matter will be of even greater importance in the event the measurement requirements of the Discussion Paper are followed because it effectively adopts a 'cost accumulation' approach during the exploration and evaluation phases of a mining or oil and gas operation.

Accounting for government imposts

There is considerable uncertainty on how certain government imposts on extractives activities should be accounted for in practice.

In many jurisdictions, mineral and oil and gas resources are considered property of the government. As a result, entities seeking to extract these resources are often subject to government imposts that seek to extract additional, or alternative, returns to the government from the 'ownership' of these resources.

These imposts can take many forms, including:

- royalties imposed on the value of production or gross profit (these tend to be low percentage amounts);
- resource rent taxes, which require the payment of a fixed proportion of returns from a mining or oil and gas project once the operator of the project has achieved a satisfactory return on the capital employed (these tend to have percentage rates);
- production sharing arrangements, where the government or a nominated body receives a share of production, with the government's capital investment often being 'free carried' and recovered from initial production (these agreements tend to vary from jurisdiction to jurisdiction and from project to project); and
- joint venture arrangements, whereby the government is a party to the operation and may or may not have substantive voting or other rights (these are project specific and often involve the government's capital contribution being 'free carried').

In practice, the structure of the systems can be complex and many systems may operate together, e.g. in some jurisdictions, resource rents paid are tax deductible for income tax purposes.

Economically, the objective of these arrangements is generally to obtain a return for the government on resources considered to vest in the government or the people it represents.

There are numerous possible accounting policies that may be applied in accounting for these types of arrangements. These include accounting for the impost as one, or potentially more, of the following:

- income tax;
- cost of production;
- other expense;
- government grant (for any benefits or additional deductions provided, particularly investment tax credits);
- joint ventures; and
- service concession arrangements (where the sales price of the extracted commodity is set by the government).

In some cases, the impost is best characterised as the government extracting a share of the 'resource rent' that participants operating the project enjoy from being given privileged access to limited public resources (i.e. the mineral or oil and gas reserves and resources).

Resource rent can be conceptualised as the excess of the returns from selling the outputs of a resource over the full costs of exploiting that resource, insofar as that excess is attributable to the value of the natural resource itself, rather than other factors (e.g. technical skills, entrepreneurship, etc).

Resource rent regimes exhibit certain characteristics that may be seen as akin to an income tax. In broad terms, these include a calculation process that yields a 'taxable income', after the allowance of certain amounts as deductions, on which the resource rent is levied (often full deductibility of capital expenditure, often in the early stages of the project). These elements may suggest the resource rent is a form of 'income tax'.

Although resource rent arrangements are sometimes represented as a form of "super profits" tax, its behavioural characteristics vary markedly in line with current commodity prices, market interest rates, the nature of the project, past exploration, capital and operating costs incurred and many other factors, depending on how the resource rent is determined. Accordingly, while resource rents may mimic the behavioural characteristics of an income tax in some situations, in other cases the effect of the allowance for recovery of costs (often with an additional allowance or return) will mean that no resource rent is paid at all, such as in relation to more economically marginal projects, even though those projects may result in significant accounting profits.

Accordingly, the economic substance of resource rent arrangements is a share of resource rent rather than a taxable profit. Imposition of resource rent levies is clearly linked to a specific resource which is considered legally owned by the government rather than on some general measure of taxable profits earned by all participants in the relevant jurisdiction.

We strongly recommend that the IASB considers how entities should account for resource rents imposed by governments including direct resource rent taxes, royalties based on profits, production sharing arrangements and similar arrangements.