

Mining and Metals Refining IFRS



IASB discussion paper on extractive activities: practical implications for the mining and metals sector

Our Refining IFRS series aims to examine the complex, but unique, issues faced by mining and metals companies applying IFRS. These issues are considered in the context of recent and current developments in the global mining and metals market place.

Background

In 2004, the International Accounting Standards Board (IASB) set up an international project team comprising staff from the national standard-setters in Australia, Canada, Norway and South Africa to undertake a detailed assessment of accounting for extractive activities. The project team's findings and recommendations are presented in their discussion paper (DP) entitled, *Discussion paper on extractive activities*, which was published in April 2010. Although the DP is a lengthy document running to some 180 pages, it is substantially narrower in scope than many commentators had predicted when the project was initiated. The IASB has discussed the project team's findings at public meetings, but has not yet decided whether it will take this project onto its active agenda. Moreover, it has not developed preliminary views on any of the project team's recommendations or made any related technical decisions. The period for comments on the DP closed on 30 July 2010. In this publication, we outline some of the key practical implications we raised in our comment letter.

Scope of the Discussion Paper

The aim of the project is to create a single accounting and disclosure model that applies to extractive activities in both the minerals and oil and gas industries. It addresses financial reporting issues associated with: exploring for and finding minerals, oil and natural gas deposits; developing those deposits; and extracting the minerals, oil and natural gas. These are referred to as extractive activities.

The DP considers:

- ▶ Definitions of reserves and resources for use in accounting
- ▶ Initial recognition and measurement of extractive assets
- ▶ Subsequent accounting for those assets (including impairment and depreciation)
- ▶ Disclosure of information (including reserves and resources information)

A significant new proposal is the requirement to disclose a current value measurement for probable reserves.

Ernst & Young's comment letter

We outlined in our April 2010 *Supplement to IFRS Outlook* a summary of the key proposals contained in the DP. The narrower scope than initially expected means a number of issues that currently present challenges to reporters will continue to exist. These include accounting for mandatory government participation, carried interests, farm-ins and farm-outs and unitisations. Without an expansion of scope, we would expect many more extractive industry specific requests for agenda items of the IFRS Interpretations Committee.

Implications for reporters

In this publication, we examine some of the most significant implications from the DP assuming the IASB adds the project to its agenda and then ultimately issues a standard in line with its proposals. We focus on the key practical implications for IFRS reporters in the areas of disclosures, cost capitalisation and measurement bases. We address how reporting requirements may change, how systems and processes may have to change, and ultimately how reporters may have to adapt their external communications with investors and analysts. All of these effects are worthy of consideration when analysing the potential impacts.

Disclosure recommendations

One of the more significant effects of the proposals is the extensive new disclosure requirements. For some reporters, this will present a major challenge to their reporting systems and processes in order to gather the required information and provide sufficient diligence over that information for it to be disclosed.

Disclosure of reserves

Some of the proposed disclosures we believe may have a significant impact on reporters are as follows:

The project team is proposing that the types of information that should be disclosed include:

- ▶ Quantities of proven reserves and proven plus probable reserves, with the disclosure of reserve quantities presented separately by commodity and by material geographical areas, including a sensitivity analysis and disclosure of primary assumptions
- ▶ A current value measurement that corresponds to reserves quantities disclosed with a reconciliation of changes in the current value measurement from year to year

Moreover, the DP is encouraging the disclosure of information beyond reserves. This addresses the fact that measured resources and indicated resources primarily have the same geological certainty as proven and probable reserves respectively, but do not yet have proven economic viability.

Sensitivity analysis

The DP recommends the disclosure of a sensitivity analysis for reserves. While this might be useful, in theory, changing one assumption, such as commodity prices, without changing all other assumptions does not faithfully represent commercial reality. In practice, should commodity prices fall, in all likelihood certain capital expenditures would no longer proceed, operating expenditures may be pared back and both of these could have a knock-on effect on the recoverability of reserves. This becomes an iterative process.

Recognising information as part of the mineral asset – particularly during the exploration and evaluation phases – will require a change in accounting policy for many entities.

Ernst & Young's comment letter

However, the project team is proposing that reasonable changes to other assumptions should be made, but the potential real impact of the iterative nature of the changes are not recognised within the DP. In our view, this would result in relatively meaningless disclosures that would be of questionable utility for users of financial statements.

Value-based disclosures

The DP also considers various approaches to value-based disclosures. The current value measurement of reserves and resources raises important questions concerning reliability of measurement and the cost benefit of such measures. For this reason, the project team does not support measuring the assets in the financial statements at a current value. However, reporters may have the legitimate concern that a move to requiring disclosure of a current value measurement of reserves may be a first step towards ultimately requiring companies to measure assets relating to reserves in the financial statements at current value.

Unit of account

The major disparity in the way that IFRS is currently applied by mining and metals companies is due to different historical definitions of units of account. The DP proposes two, sometimes conflicting, biases - contiguous geographical areas and independent cash flows; although the DP has clear bias to smaller units of account.

Publish what you pay

The final section of the DP relates to the "Publish what you pay" proposals. The disclosures would require companies to disclose amounts paid to host governments on a country-by-country basis. This would be a potentially significant undertaking to collate all the relevant information.

At this stage, the proposals do not detail exactly what types of payments to governments should be captured, but the burden of collating this information for global IFRS reporters is potentially significant. Many resource-rich countries have not yet signed up for initiatives such as the Extractive Industry Transparency Initiative, therefore, requiring mining and metals companies to disclose payments to governments would require the reporters to undertake significant additional work without the full benefits of disclosure. It should be noted that the recently passed *US Financial Reform Bill* also includes provisions obligating US resource extraction issuers to disclose payments made to governments, but it is not yet clear whether this will be consistent with the "Publish what you pay" disclosures.

Cost capitalisation model

The DP proposes that the legal rights to explore and extract minerals should be recognised as an asset. Associated with these legal rights is information about the possible existence of mineralisation, the extent and characteristics of the deposit, and the economics of their extraction. While such information does not represent a separate asset, the project team proposes that recognising the cost of obtaining this information as part of the cost of the mineral rights - particularly during the exploration and evaluation phases - will require a change in accounting policy for many entities. The DP is essentially proposing that all exploration costs would now be capitalised as they provide further information about the legal right. It is not yet clear what the implications would be of so-called "bad/negative information", particularly where it can be challenged whether such exploration information enhances the value of the asset.

Examples of changes to policies that may be required are:

- ▶ Reporters that currently expense pre-drilling costs would have to capitalise all such costs
- ▶ Reporters that currently expense geological and geophysical costs would have to capitalise these costs
- ▶ Reporters that apply some form of successful efforts accounting would have to capitalise any exploration costs they are currently expensing
- ▶ In addition, IFRS 6 currently suggests "prospecting" costs should be expensed, but again these would be capitalised if they led to the acquisition of a license under the DP

This suggests that the DP, as drafted, would in fact result in accounting changes for virtually all reporters.

How will costs be charged to the Income Statement?

More costs are likely to be capitalised than under current guidance due to the requirement to capitalise all exploration costs, and the potential for impairment tests arising from disappointing drill results. Consequently, we expect an increase in the number of impairments being recognised in the early phases of mineral exploration projects, and increased earnings volatility as a result. Costs that previously would have been recognised by many companies in the income statement as periodic costs now will accumulate on the balance sheet and potentially will have to be written off at a later date. This volatility will present challenges for reporters in managing users' expectations and describing the underlying performance of the business.

In addition, many reporters treat impairment charges as "non-recurring" or "special" items that are often excluded when "underlying earnings" are reported. The investor communication strategy may need to be reconsidered if impairment charges are recognised on a more regular basis as a result of the new model.

Furthermore, companies will be required to disclose why they believe the carrying amounts of their exploration assets are not impaired. At this stage, it is unclear what would be an acceptable disclosure in this regard. But the more detailed the requirement, the closer the requirements will be to a fair value model because companies will effectively have to perform valuations to assess whether assets are impaired. A further complication is the difficulty associated with estimating the value of assets so early in the project lifecycle.

Fair value or historical cost

Another of the more significant impacts for reporters under a fair value measurement basis is how to communicate performance to the users of financial statements. This would be significantly different from current performance reporting, given the potential for large swings in the fair value of mineral assets that would be reported as gains or losses. Explaining such performance to investors will represent a real challenge to all reporters.

In addition, the large number of variables, and therefore subjectivity, that would go into a valuation means fair value could only be provided usefully by the entity if there was extensive disclosure of the assumptions used. This is further complicated as management would have to provide additional evidence to support these disclosures, when an audit opinion is required.

Reporters will want to avoid potentially burdensome disclosures and unnecessary changes to embedded policies and processes unless it is clear that the changes are what users are looking for, and that the costs of change are outweighed by the benefits to financial reporting.

Ernst & Young's comment letter

As a result of these issues, the project team has concluded that mineral assets should be measured at historical cost and that detailed disclosures should be provided to enhance the relevance of the financial statements. However, the option of measuring mineral assets at fair value has been left on the table for commentators to respond to the IASB as part of the comment process.

Conclusion

Despite its relatively limited scope, the DP includes a number of provisions that may affect both accounting policies and disclosure requirements of small and large companies alike. Reporters will want to avoid potentially burdensome disclosures and unnecessary changes to embedded policies and processes unless it is clear that the changes are what users are looking for and that the costs of change are outweighed by the benefits to financial reporting. At the same time, the IASB will face the challenge of pitching the standard at the right level to apply to both oil and gas and mining companies, without compromising the detail required to ensure consistency of application. What is clear is that the DP as it is currently drafted will have some significant impacts for many reporters.

Ernst & Young's Global Mining & Metals Centre

With a strong outlook in the sector, the global mining and metals industry is focused on future growth through expanded production, without losing sight of operational efficiency and cost optimization. The sector is also faced with the increased challenge of changing expectations in the maintenance of its social license to operate and meeting government revenue expectations.

Ernst & Young's Global Mining & Metals Centre brings together a worldwide team of professionals to help you achieve your potential - a team with deep technical experience in providing assurance, tax, transactions and advisory services to the mining and metals sector.

The Centre is where people and ideas come together to help mining and metals companies meet the issues of today and anticipate those of tomorrow. Ultimately it enables us to help you meet your goals and compete more effectively. It's how Ernst & Young makes a difference.

Global Mining & Metals and Australia

Leader

Mike Elliott
Tel: +61 2 9248 4588
michael.elliott@au.ey.com

China

Peter Markey
Tel: +86 21 2228 2616
peter.markey@cn.ey.com

Japan

Kentaro Nakamichi
Tel: + 81 3 5401 6407
kentaro.nakamichi@jp.ey.com

Europe, Middle East, India and Africa Leader

Michael Lynch-Bell
Tel: +44 20 7951 3064
mlynchbell@uk.ey.com

Africa

Adrian Macartney
Tel: +27 11 772 3052
adrian.macartney@za.ey.com

Commonwealth of Independent States

Evgeni Khrustalev
Tel: +7 495 648 9624
evgeni.khrustalev@ru.ey.com

France and Luxemburg

Christian Mion
Tel: +224 30 41 21 82
christian.mion@fr.ey.com

India

Anjani Agrawal
Tel: +91 982 061 4141
anjani.agrawal@in.ey.com

United Kingdom

Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Americas and United States Leader

Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

Canada

Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

South America and Brazil Leader

Carlos Assis
Tel: +55 21 2109 1606
carlos.assis@br.ey.com

Argentina

Pablo Decundo
Tel: +54 11 4515 2684
pablo.decundo@ar.ey.com

Colombia

Joss McGregor
Tel: +57 1 484 7120
joss.mcgregor@co.ey.com

Chile

Alicia Dominguez
Tel: +56 2 676 1207
alicia.dominguez@cl.ey.com

Peru

Marco Antonio Zaldivar
Tel: +5711 411 4450
marco-antonio.zaldivar@pe.ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organisation of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

For more information about our organization, please visit www.ey.com

© 2010 EYGM Limited. All Rights Reserved.
SCORE Retrieval File AU0597

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.

www.ey.com/miningmetals