

30 July 2010

International Accounting Standards Board
30 Cannon Street
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Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON THE DISCUSSION PAPER ON *EXTRACTIVE ACTIVITIES*

In response to your request for comments on the IASB's discussion paper on *Extractive Activities*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

This comment letter includes comments received from members of the South African mining industry.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Prof Alex Watson – Chairman of the Accounting Practices Committee

cc: Moses Kgosana (Chairman of the Accounting Practices Board)

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GENERAL COMMENTS

We commend the project team for their research work which it has undertaken to address the diversity that currently exists in practice and the complex accounting requirements, particularly on the measurement requirements, for extractive activities. We do acknowledge that some of the inconsistent accounting practices would not be eliminated in the short-term, but we are still of the view that the proposals contained in the discussion paper are a step in the right direction towards addressing some of the issues that currently exist.

SPECIFIC COMMENTS

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 that the proposed scope of an IFRS on extractive activities should be limited to upstream activities for minerals, oil and natural gas.

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 that a single accounting and disclosure model should be applied to extractive activities because conceptually the main business activities and overall risks and uncertainties are very similar in the minerals and oil and gas industries. It therefore makes sense to have consistent principles regarding the accounting treatment and the disclosures. When it comes to disclosures, it is feasible that there could be differences in the specific information required given the differences between these industries.

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 support the proposal that the definitions of mineral reserve and resources be based on those established by the Committee for Mineral Reserves International Reporting Standards

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(CRIRSCO) and the oil and gas reserve and resource definitions established by the Society of Petroleum Engineers (in conjunction with other industry bodies).

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?

We agree that the legal right (exploration or extraction right) meets the definition and recognition criteria for an asset, and accordingly should be capitalised.

Most of our commentators see the legal right as being separate from the exploration and evaluation activities. We do not believe that the costs incurred in the exploration and evaluation activities should be capitalised merely because the legal right is treated as an asset. Accordingly, the asset definition and recognition criteria should be applied separately to these different items. We are concerned about the point in time at which the subsequent exploration and evaluation activities meet the definition and recognition criteria for an asset. We are also concerned that in the early stages of exploration and evaluation it will not be possible to demonstrate that an asset exists that will generate probable future economic benefits. The uncertainty is too great. This is analogous to the research phase of a research and development project under IAS 38, *Intangible Assets*.

It is often contended that because exploration rights are sold, either on their own or as part of a business combination, these rights are assets. We concur, which is why we agree that the legal rights are assets. We also acknowledge that the value of these rights would be affected by the exploration and evaluation work that has already been done. We see this as analogous to a situation in which an entity acquires in-process research and development via a business combination, which did not qualify for recognition as an asset for the seller under IAS 38. The buyer would recognise what they have acquired as an asset in terms of IFRS 3, *Business Combinations*. However, any subsequent research expenditure on this in-process research and development acquired, would need to be expensed.

Accordingly, we propose a later recognition date for the asset arising from exploration and evaluation activities, which should be the date on which the definition and recognition criteria are met. We believe that more analysis needs to be done to determine whether the proposed IFRS should prescribe the point in time (for example, the date of declaration of inferred resources or the date proved and probable reserves are identified) or whether only principles for capitalisation should be provided. These could be similar to those in IAS 38 for the capitalisation of internally generated intangible assets.

A minority of our commentators is supportive of the discussion paper’s proposal that there is one asset, i.e. the subsequent exploration and evaluation activities are not seen as items separate from the legal right. However, having capitalised the costs of the subsequent exploration and evaluation activities, they are concerned about the complexities of impairment testing. Some of these commentators have suggested that under the discussion

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paper's approach they would impair the asset on day two and would reverse the impairment once there was more certainty about the existence of future economic benefits.

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 recognized 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 agree, subject to our response to Question 4 regarding the timing of recognition as an asset.

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 (see Chapters 5 and 6).

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.

We support the project team's view that the historical cost measurement model be applied to mineral, oil and gas properties, coupled with detailed disclosures for the same reasons expressed by preparers as provided in paragraph 4.24 of the discussion paper. We believe that this measurement basis is the 'lesser of two evils'. In addition, if users have indicated that they would not use management's determined value (current value or fair value) in performing their analysis of a company's value, it would be superfluous for management to provide such measurements.

Some of our commentators are of the view that the fair value model would provide more useful information than the historical cost measure in some instances, for example an exploration company that routinely sells its exploration rights once it has found reserves which can be developed. Conversely, the historical measurement model would be more appropriate for property held with the intention of being developed by the entity. Therefore,

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we encourage the consideration of an alternative measurement model that reflects the entity's business model (similar to the approach adopted in IFRS 9 *Financial Instruments*).

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?

We are concerned that the impairment proposals are weak and are highly likely to result in the overstatement of assets. The acknowledgement that enough information to determine the recoverable amount is not likely to be available for most exploration and evaluation activities brings into question whether those items met the definition and recognition criteria for assets upon initial recognition. Please refer to our response to Question 4 noting that most commentators believe that these activities only give rise to an asset once there is more certainty around the future economic benefits.

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?

Yes, we agree the project team's proposed disclosure objectives for extractive activities.

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;*

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- (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 the above disclosures should be included in an annual report. There were differences of opinion as to whether such information should be required to be in the audited set of financial statements.

In addition to the above-mentioned disclosures, we propose that entities be required to provide following disclosures about resources (information added has been underlined) because we believe that resources are the future lifeblood of an extractive activity. Reserves are those portions of the resources that are currently extractable under present conditions; whereas the balance of the resources are those which could become extractable if current conditions change:

- quantities of proved reserves and proved plus probable reserves, inferred, indicated measured resources, with the disclosure of reserve and resource quantities presented separately by commodity and by material geographical areas;
- the main assumptions used in estimating reserves and resource quantities, and a sensitivity analysis;
- a reconciliation of changes in the estimate of reserves and resource quantities from year to year;
- a current value measurement that corresponds to reserves and resource quantities disclosed with a reconciliation of changes in the current value measurement from year to year.

Moreover, entities should be required to provide disclosures on impairment of their exploration property.

With regard to the disclosure of a current value measurement (see (c) above), most of our commentators (preparers and auditors) questioned the usefulness of such a measure based on standardised inputs. There is also concern about what this measurement represents and that it may be misinterpreted to be an indication of fair value. Therefore, we do not think that such disclosures should be required.

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

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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 believe that the costs would probably not be that significant if the disclosures were only required at a consolidated level rather than at a subsidiary level where materiality thresholds would be lower.

Some commentators noted that investors who use PWYP disclosures to assess the ethical merits of an investment currently represent a small proportion of investors. Accordingly, they are of the view that this information may not be used that widely to warrant the requirement for its inclusion in the financial statements.

We do question whether it is appropriate for an IFRS to mandate such disclosures or whether there are other industry initiatives which should be focusing on this. For example, the Extractive Industries Transparency Initiative (EITI). There is an increasing trend to greater transparency on the part of the mining industry in all matters of public interest and we note that many mining companies already subscribe to the EITI, which endorses transparency disclosures, similar to PWYP.

Also we do have concerns where governments may not want such information to be disclosed publicly. This could create tension especially since governments are responsible for awarding mining licences.

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