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Dear Kevin

INVITATION TO COMMENT ITC 23 & DISCUSSION PAPER DP/2010/1 – EXTRACTIVE INDUSTRIES

Grant Thornton Australia Limited (Grant Thornton) is pleased to provide the Australian Accounting Standards Board with its comments on ITC 23 which is a re-badged copy of the International Accounting Standards Board's (the Board) Discussion Paper DP/2010/1 (the Paper). We have considered the DP and set out our comments below.

Grant Thornton's response reflects our position as auditors and business advisers both to listed companies and privately held companies, and public and private businesses, and this submission has benefited with some initial input from our clients, Grant Thornton International which is working on a global submission to the IASB, and discussions with key constituents.

The views expressed here are preliminary in nature, and a more detailed Grant Thornton global submission will be finalised by the IASB's due date of 30 July 2010.

Our main comments and suggestions on the issues raised in the Paper are summarised below. Our responses to the Invitation to Comment questions, and the AASB's request for comments are set out in the Appendix.

General Comments

Support for pursuing a project on extractive activities

We support the IASB's objective in developing guidance for entities that undertake extractive activities. Although we are not generally in favour of industry-specific standards (and would not support their proliferation) we believe there is a strong case for pursuing this project. This is on the grounds that:

- the extent of costs incurred in pre-development activities and the uncertainties faced, while not unique to this sector, are highly significant

- generic IFRSs deliver little (if any) useful information about oil & gas or mineral reserves
 - generally considered to be essential information in this sector
- many other national standards-setters have previously concluded that industry-specific guidance is called for in this area
- IFRS 6 *Exploration for and Evaluation of Mineral Resources* was designed only as an interim solution and sanctions alternative accounting treatments for activities within its scope, which is limited to the exploration and evaluation phase of the operating cycle
- we believe that current accounting practices for many types of transaction and arrangement in this sector are inconsistent (see below).

These factors indicate that specific guidance should be developed in order to improve consistency and better serve users' needs.

The proposals

General comments

We generally support the parameters and approach taken by the project team in conducting its research. We particularly commend the team's extensive engagement with users.

We note that the Paper focuses on asset recognition, measurement and disclosure in relation to extractive activities, which are clearly important. We believe however that there is also a potential need for additional guidance on the application of general IFRSs to some transactions and arrangements commonly encountered in this sector. Such transaction types might include farm-in/farm-outs, production, cost and risk-sharing arrangements, unitisations and re-determinations etc. In this context we note that the IFRS Interpretations Committee is currently considering the accounting for production stripping costs.

Recognition and measurement proposals

In summary, the Paper proposes a recognition and measurement model that capitalises "information" costs from the point at which an entity has legal rights to explore a defined area. We believe this model would be a substantial deviation from general IFRS principles, and seems to ignore the "probability of economic benefits" part of the definition of an asset.

The Paper does not in our view make a compelling case for this proposal. The project team's research indicates that users would derive little benefit from the amounts capitalised. We are also not persuaded by the conceptual arguments offered in Chapter 3. The proposed model creates and/or exacerbates related problems concerning unit of account and impairment.

We suggest that the project team should instead consider how general IFRS principles and definitions on asset recognition, and IAS 38 *Intangible Assets* in particular, should be applied to extractive activities. This is likely to result in immediate expense recognition for most exploration and evaluation costs, and some development costs. We believe that amounts expensed should be disclosed in order to maintain transparency, possibly on the basis of cumulative and current costs incurred by property.

We do however agree with the project team's view that the balance of arguments supports a cost-based measurement for extractive activity-related assets that do qualify for recognition.

Disclosure

We agree with many aspects of the project team's proposals on disclosure but disagree with some. We agree that information about entities' reserves is critical but would prefer to limit the required financial statement disclosure to proved reserve quantities. We also support the disclosure of a discounted cash flow measure of proved reserve quantities, which in our experience assists users in making comparisons between entities.

Although we have not undertaken a detailed technical evaluation of the CRIRSCO Template or PRMS reserve definition, we agree that the use of standard, industry-based definitions will promote comparability. Using definitions set by appropriately qualified experts should enhance the quality and credibility of the information provided.

In our view, however, the Paper does not make a convincing case to require disclosure of the fair value of oil & gas or mineral properties. We believe this disclosure would be costly for preparers and would not deliver commensurate benefits for users.

Non-Publicly Accountable Entities

We note that the IASB has not indicated whether it will amend the existing requirements for non-publicly accountable entities that are undertaking extractive industries activities. The IFRS for SMEs accounting standard just refers to the accounting requirements contained in Section 17 Property, Plant and Equipment and Section 18 Intangible Assets other than Goodwill and Section 21 Provisions and Contingencies (21 pages in total).

Grant Thornton does not believe that at this time a final IFRS standard should be mandatorily applied to non-publicly accountable entities given the complexity and costs associated with what is a 180+ page Paper. To require non-publicly accountable entities to adopt an IFRS Extractive Industries accounting standard would add significant complexity and costs that would not be borne by similar structured overseas entities.

If you require any further information or comment, please contact me.

Yours sincerely
GRANT THORNTON AUSTRALIA LIMITED



Keith Reilly
National Head of Professional Standards

Appendix 1: Responses to Invitation to Comment Questions

Invitation to Comment 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 the proposed scope, in particular the focus on upstream activities. We agree with that downstream activities are not sufficiently dissimilar to many other industries to justify specific guidance.

We are not aware of any other similar activities that we consider should be within the scope 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 in principle that a single accounting and disclosure model can be used for extractive activities related to both oil & gas and minerals.

We also note that, in some jurisdictions, oil & gas and minerals are subject to different accounting requirements. This is sometimes explained based on differences in the activities involved, with oil & gas having more of a "discovery orientation" and minerals a "development orientation". However, while some differences exist we suggest these are matters of degree and emphasis that are not fundamental to a financial reporting standard.

Notwithstanding the differences, for financial reporting purposes we agree with the project team that the underlying issues and challenges are similar.

As a practical matter, we believe that the wider acceptance of a single model may depend in part on the nature of that model and the extent of change required to adopt it. From a global perspective, we believe that the capitalisation of exploration and evaluation costs is more familiar in the oil & gas sector (under so-called full cost accounting) than in the minerals sector. The project team's proposed model seems likely to be similar in its effect to full cost accounting (we comment on the proposed model in our response to Question 4).

We also believe users' needs in relation to oil & gas and minerals are essentially the same.

Finally we note that IFRS 6 also covers both oil & gas and minerals.

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 approach (although we have not undertaken a detailed technical evaluation of the CRIRSCO Template or PRMS reserve definition). We agree in particular with the project team that the most important information in relation to extractive activities concerns an entity's reserves.

In reaching this view we considered alternative strategies that could be pursued, for example:

- development of a principle-based definition by the IASB
- allowing management to select among a range of industry-accepted definitions (with appropriate explanatory disclosure)
- disclosure based on information used by management (also with appropriate explanatory disclosure).

We prefer the project team's approach to these alternatives on the grounds that we believe:

- comparability is critical
- high quality, credible disclosures are most likely to be achieved if based on definitions set by appropriately qualified experts and internationally recognised organisations.

**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 do not agree with the project team's analysis. Our reasons are set out below.

We agree with the analysis in so far as legal rights to explore a defined area meet the definition of an asset. We view the purchase of legal rights as a separate acquisition of an intangible asset that should be recorded at cost (consistent with IAS 38 *Intangible Assets*).

However, in our view treating the cost of obtaining information from subsequent exploration and evaluation activities as an enhancement to the legal rights asset is a substantial deviation from general IFRS principles. We view this "information resource" as a separate item, not an enhancement to the acquired legal rights. The proposal to recognize these costs as an asset seems to ignore the "probability of economic benefits" part of the definition of an asset. It is also not consistent with the principles of IAS 38 for internally developed intangibles.

The effect of the proposed model is that amounts would be recognized in the statement of financial position irrespective of whether the reporting entity expects to recover those amounts. Costs that are expected to be recovered would be reported in the same way as those that are not. This would in our view fail to achieve increased comparability because it would make dissimilar economic circumstances appear similar.

We also note that this aspect of the model causes or exacerbates related issues of unit of account and impairment.

Finally, the Paper itself notes that the resulting information is not useful (although we acknowledge that this is a wider concern regarding the usefulness of capitalized amounts).

We suggest instead the project team should consider whether there is a need for additional guidance on how to apply the general principles of IFRS, and IAS 38 in particular, to extractive activities. For example, guidance on possible links between the recognition point for an asset and the technical stage of an inferred reserve might be useful in promoting more consistent accounting practices in this sector.

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 that unit of account is a significant issue in financial reporting for this sector. The level of (dis-)aggregation affects the timing and manner in which capitalized costs are recognized as expenses (via amortization, impairment and de-recognition).

However, we believe that the problems associated with unit of account (a concept not well developed in IFRS generally) are significantly exacerbated by the capitalization of costs in the pre-development (exploration and evaluation) phase. This proposed model creates a greater need for allocation of costs incurred in an initial area of exploration to the productive asset(s) that might ultimately be developed. Put another way, it gives rise to a longer "asset continuum" - through which the unit of account may contract. This issue is less acute if costs are capitalized only when IAS 38's criteria for recognition of internally developed assets are met. The unit of account is then defined primarily by what is being developed.

We agree that some guidance on unit of account is nonetheless needed. This would determine whether the development is of a single asset or multiple assets. The unit of account for extractive activities should be principle-based and allow sufficient flexibility to deal with the wide range of facts and circumstances encountered. An indicator approach would in our view be appropriate, with indicators based on:

- independence of cash flows
- geographic separation (although we have concerns about the "no greater than a single area, or group of contiguous areas" constraint)
- management processes; and
- risks.

We also suggest that the Paper should distinguish more clearly between an asset and components of an asset, noting that:

- a single asset is the lowest level at which impairment is assessed in accordance with IAS 36 *Impairment of Assets*
- a single asset might however be disaggregated into components for depreciation and de-recognition purposes (we agree with the project team that the guidance on componentization in IAS 16 *Property, Plant and Equipment* is relevant in this context).

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 agree that the balance of arguments supports a cost-based approach. The additional costs and subjectivity involved in fair value measurement can be justified only if there is a strong demand from users.

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:

- 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
- 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 do not agree with the project team's recommendations in this area.

The Paper sets a higher threshold for recognizing impairment than IAS 36 ("high likelihood"). We are not convinced this is justified, for the following reasons:

- many of the issues raised with IAS 36 are in fact broader criticisms of that Standard (which is acknowledged in the Paper)
- frequent impairment testing seems an appropriate quid pro quo for recording assets prior to having a probability of economic benefit
- the argument that any new information could be an impairment indicator is questionable.

We believe that the practical problems associated with determining recoverable amount are largely a consequence of capitalizing costs incurred prior to reaching a probability of recovery threshold. The information required to demonstrate the necessary probability of recovery (including evidence of technical feasibility and commercial viability) would also facilitate impairment testing. We agree that the project team should consider the need for more specific and customized indicators of impairment (Option C in the Paper).

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

- the value attributable to an entity's minerals or oil and gas properties;
- the contribution of those assets to current period financial performance; and
- 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 believe that the proposals on disclosure objectives are appropriate. However, the overarching theme should be usefulness in predicting future cash flows (which is not referred to in the Paper). The IASB's ongoing conceptual work on a disclosure framework should in due course inform the development of standards-level objectives.

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:

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

- the main assumptions used in estimating reserves quantities, and a sensitivity analysis;
- a reconciliation of changes in the estimate of reserves quantities from year to year;
- a current value measurement that corresponds to reserves quantities disclosed with a reconciliation of changes in the current value measurement from year to year;
- separate identification of production revenues by commodity; and
- 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?

General comment

We believe that the needs of users are paramount in specifying an appropriate suite of disclosures. Costs and other practical considerations for preparers and auditors must also be taken into account. We commend the project team for seeking to obtain input from users on the extent to which this information is useful and the manner in which it is used.

Reserves disclosures

We agree with the project team's comment that reserve quantity disclosures are critical. As commented in our response to Question 3, we also agree that a consistent approach to these disclosures is important.

We do not agree that the mandatory disclosures should cover proved and proved plus probable reserves. We suggest instead that the mandatory disclosures should be limited to proved reserves. Companies can provide supplemental information on probable (and possible) reserves, although we believe this information is more appropriately presented outside the audited financial statements. In our view information on probable and possible reserves must also be distinguished clearly from the proved reserves data. Our reasons to limit the disclosure to proved reserves are that:

- we share the concerns expressed by some commentators set out at paragraph 5.30
- in particular, we believe that practical usefulness of information about probable and possible reserves is diminished by the need to understand and evaluate the associated risks and qualifications
- in many jurisdictions extractive entities' technical reserves data are publicly available through regulatory filings or other sources.

We agree with the team's analysis that it should be possible to provide reserves information (whatever its scope) outside the audited financial statements. This is on the basis that we share the concerns raised at 5.20-23 regarding audit implications.

Value disclosures

We agree with the proposal to disclose a discounted cash flow (DCF) measure of the entity's reserves, possibly using a standardised model (Approach B in the Paper). In our experience, this information is useful to users of financial statements in making comparisons between entities. Having said that, we recognise that specifying a standardised measurement model internationally, and for both oil & gas and minerals reserve, will present challenges.

We believe that the scope of DCF measure disclosures should be the same as the quantity disclosures (and therefore limited to proved reserves in our view).

We note that estimation of proved reserve quantities using industry-based definitions (including the CRIRSCO Template and PRMS reserve definitions) requires inputs concerning economic conditions. We believe that the inputs to DCF measures should be consistent with the inputs to determination of proved reserve quantities.

The DP does not make a convincing case to require disclosure of the fair value of minerals and oil & gas properties (Approach A). The DP indeed notes (at paragraph 5.79) that many of the concerns raised over possible use of fair value in the primary statements also apply to disclosure. We believe this Approach would impose significant costs on preparers (noting that each property is unique, that market transactions are infrequent and that transaction prices are typically not publicly available). The project team's research indicates that the resulting information will not be of significant use to users.

Other disclosures (production revenues and costs)

We have no significant comments or concerns.

In developing the proposals further the IASB should seek to ensure that the required disclosures do not duplicate or overlap other requirements (for example disclosures specified in current or proposed standards on operating segments, financial statement presentation and revenue recognition).

We comment in the main body of this letter, and in our response to Question 4, that we do not agree with the project team's recognition and measurement proposals. We favour an approach that would result in immediate expensing of exploration and evaluation costs. Under our preferred approach we believe additional disclosure will be necessary to provide transparency about entities' exploration, evaluation and development costs. This could be achieved by disclosing the expenses incurred, possibly analysed as cumulative and current period costs by property.

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.

While we do not disagree that information on payments made to governments might be useful to capital providers in making their investment and lending decisions, it appears that users' needs may not be the primary motivation for these disclosure proposals.

In our view these proposals should be carried forward if, and only if, justified in terms of the normal objectives of general purpose financial statements.

AASB Request for comments

The AASB would particularly value comments on the following:

- 1 *Whether there are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:*
 - a *not for-profit entities; and*
 - b *public sector entities;*

We are not aware that there are regulatory or other issues arising in the Australian environment, apart from our earlier comments on the proposals.

We believe that there are regulatory and other issues arising in the Australian environment for non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

- 2 *whether, overall, the proposals would result in financial statements that would be useful to users.*

We are not aware of any reasons that would impact on the usefulness of these proposals to users for publicly accountable entities, apart from our earlier comment son the proposals.

However we do not believe that these requirements should apply to non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.

- 3 *whether the proposals are in the best interests of the Australian and New Zealand economies.*

For publicly accountable entities, apart from our earlier comments on the proposals, we are not aware of any reasons that would impact on the interests of the Australian economy and our New Zealand firm will comment direct to the AASB if there are any New Zealand implications.

We do not believe that these requirements should apply to non-publicly accountable entities as the proposed requirements would add significant complexity and costs that would not be borne by similar structured overseas entities.