Energy and resources

New guidance on accounting for stripping activities – a big issue for the energy and resources industry

Application date: A draft interpretation was issued in August 2010. In 2011, the IFRIC will continue their deliberations with a view to issuing an interpretation later in 2011.

What's new?

The International Financial Reporting Interpretations Committee (IFRIC) has now published a draft interpretation (DI) on stripping costs that may have significant "day one" impacts for mining companies. The interpretation sets out guidance on the accounting for waste removal (stripping) costs in the production phase of a mine. The comment letter period closed in November 2010.

Who from this sector is impacted?

The stripping costs DI will impact all companies with open-pit (surface) mines. The new guidance applies to stripping costs that are incurred in open-pit mining activity during the production phase of the mine. These costs are often significant for open-pit mining operations where waste and ore are typically mined together. The DI would require management to make significant judgements and could result in a need for considerable changes to reporting processes for most entities to deliver the relevant information.

What are the overarching proposals?

The key elements of the proposals and the effect on the financial statements are outlined below.

- Costs of stripping activities incurred during the production phase would be capitalised as a stripping cost asset whereas routine stripping costs would be expensed.
- Stripping cost assets would be classified according to the nature of the existing asset to which it relates.
- Stripping cost assets would initially be measured at cost and subsequently carried at cost less depreciation and impairment.
- The proposals would be applied prospectively from the date of adoption, with any existing stripping cost assets being reclassified as a component of the asset to which it relates.

There are several issues for entities in the resources sector to consider, including:

- whether the definition of an asset is met;
- when the stripping component should be recognised; and
- how the stripping campaign component should be measured at initial recognition and thereafter.

Meeting the definition of a stripping cost asset

The stripping activity creates a benefit of improved access to the ore to be mined for the entity. The benefit of improved access to the ore will qualify as an asset when:

- an entity controls the benefit created by the stripping activity by either owning the land which it is mining or owning the rights to mine the land;
- the benefit arises as a result of stripping activity, therefore "as a result of past events"; and

- a future economic benefit will flow to an entity through improved access to the ore that is expected to be economically recoverable in the future.

Routine stripping costs that are not part of a stripping activity should be accounted for as a current production cost in accordance with IAS 2 Inventory. Stripping costs that are part of a stripping activity should be accounted for as an addition to, or enhancement of, an existing asset (stripping component). The stripping component should be specifically associated with the component of ore that becomes more directly accessible as a result of the stripping activity. The DI proposes this "specific association" approach in preference to the "strip ratio" approach which is currently used by many in the industry.

Recognising the stripping cost asset

The DI proposes that the stripping asset should be recognised as the stripping activity takes place and the costs of creating that asset are incurred.

An entity shall capitalise stripping costs in the production phase of a mine when the benefit created by the stripping activity is expected to be realised in a future period.

In order to apply this principle, an entity must be able to:

- identify the ore body (or component of the ore body) in the component of the mine, for which access has been improved by the stripping activity; and
- measure with reliability the costs of that stripping activity.

Measurement – basic principle

The stripping asset should be measured initially at cost and be directly incurred to perform the stripping activity (eg, haulage, waste transportation, materials consumed, labour, fuel etc). Ancillary activities associated with these operations should not be included in the cost of the stripping component.

The stripping asset should subsequently be measured at cost less depreciation and any impairment losses. The component should be depreciated in a rational and systematic manner over the expected useful life of the specific component of the ore body that becomes directly accessible as a result of the stripping activity using the units of production method unless another method is more appropriate.

Measurement of stripping activity with future benefit

Some entities conduct stripping activities with a view to mining the accessible ore in the current period, and some in a future period. In this case, the production stripping costs need to be split between the current and the future period, according to when the benefit of the production stripping activity is realised.

The current proposal is that the entity shall allocate the production stripping costs between the inventory produced and the stripping cost asset on a rational and consistent basis, where the costs of the stripping cost asset and the inventory produced are not separately identifiable.

The allocation basis should reflect a production metric for example:

- cost of inventory produced compared with expected cost;
- volume of waste extracted compared with expected volume, for a given volume of ore production; and
- mineral content of the ore extracted compared with expected mineral content to be extracted.

Potential impacts on practice

The proposals mean more work and more resources as the DI would require management to make significant judgement in terms of distinguishing between normal mining activities and a stripping activity. Management will need to identify the associated component of the ore benefiting from the stripping activity; and setting up the amortisation calculations, which will be more complex than what many companies are used to.

Given the increased involvement of management and the data gathering exercise, implementation will be costly for many companies.

The DI may also result in significant profit and loss volatility compared to the strip-ratio method, which aims to achieve a higher level of consistency in allocating stripping costs to reserves over the life of the mine.

Under the proposals, any existing stripping cost balances need to be reclassified as a component of the mine asset to which the stripping activity related. Any components that can't be associated with specific identifiable ore would need to be written off to profit and loss at the beginning of the earliest period presented.

Management will need to allocate the relevant costs to the stripping activity to appropriately classify the costs as part of the mine asset or expense in the profit or loss. Stripping costs which are reclassified as a component of the mine asset are depreciated or amortised over the related specific ore quantity.

What are the next steps?

The IFRIC are currently conducting an analysis of the changes to the draft interpretation with a view to potentially re- exposing the interpretation.