Financial reporting in the oil and gas, power and utilities and mining sectors

The roundtable
Over 100 senior executives and experts from around the world gathered in London, UK for PwC’s September 2011 roundtable on the financial reporting challenges facing oil and gas, mining, power and utility companies arising from changes in International Financial Reporting Standards (IFRS). Participants were drawn from 40 different energy, utilities and mining companies as well as representatives from the standards-setting body itself – the International Accounting Standards Board (IASB). In a truly global event, attendees came from Russia, UK, Netherlands, Germany, Switzerland, Spain, Italy, France, Denmark, US and the United Arab Emirates.
Introduction

International Financial Reporting Standards provide a basis for company reporting in an increasing number of countries around the world. Today, over 100 countries either use or are in the course of adopting IFRS. The pace of standard setting from the IASB has been intense in the recent years with a constant flow of changes for companies to keep up with.

Introducing the roundtable event, PwC’s Global Power and Utilities Leader Manfred Wiegand pointed out: “It’s not just the IFRS standards that are constantly evolving, but also the operational issues faced by energy, utilities and mining companies, and certainly the market environment that we see evolving today. One of the biggest challenges of any reporting standard is how best to interpret and implement it in the context of a specific company or industry, especially in such complex sectors as we have in the room here today.”

The event coincided with the publication of two PwC global handbooks on the application of IFRS in the oil and gas industry and in the power and utilities sector, as well as the announcement of a third publication covering mining.
“It’s not just the IFRS standards that are constantly evolving, but also the operational issues faced by energy, utilities and mining companies.”

This report provides an in-depth summary of discussions during the roundtable. We focus our summary on:

- **Headline IFRS developments and future direction** page 4
- **Hot topics – joint arrangements, revenue recognition, leasing and hedge accounting** page 6
- **Breakouts – oil and gas, power and utilities and mining** page 12
- **Review – some of the big messages emerging from the roundtable** page 20

*The IASB encourages expressions of individual views by its members and its staff. The views of IASB members and staff quoted in this publication are those of the individuals identified, and not necessarily those of the IASB or the IFRS Foundation. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.*
Surveying the ground to be covered by the roundtable event, IASB board member Patrick Finnegan observed: “This is an agenda that is filled with an extraordinary number of issues, both in terms of its breadth and depth. When we get into these topics, the breadth of opinions and perspectives that we hear never cease to amaze me.”

Finnegan also picked up a point touched upon in Manfred Wiegand’s introductory remarks: “There’s been good reason for us to be very methodical and, in fact, to slow down the intense pace, as Manfred just described, of standard setting. On the other hand, we won’t be going back to the old glacial pace of setting accounting standards, which in my view is not very helpful for those who use financial statements to make investment decisions.”

The coming period will be an important one in terms of setting the agenda for IFRS development for a significant time ahead. The IASB has launched its first formal agenda consultation. Finnegan pointed out: “The decisions we make in the next 18-24 months will steer the direction of where the Board is going over the next decade. We will have a rotating three year call for input into the agenda but the reality is that, once you select projects, they don’t only take three years to complete.”

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### Headline IFRS developments and future direction

**“Setting course for the next decade”**

#### IFRS development – some highlights

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<th>Three new standards in May 2011:</th>
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<td>IFRS 10 Consolidated financial statements</td>
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<td>IFRS 11 Joint arrangements</td>
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<th>New interpretations:</th>
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<td>IFRIC 20 Stripping costs in the production phase of a surface mine – issued October 2011</td>
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The future agenda will need to balance development of new standards with maintenance of existing ones. Finnegan stressed that the maintenance demands on the IASB’s activity will grow considerably as the number of standards itself grows. “It’s inevitable over time that a body of principle-based standards will evolve into a body of both principles and rules. If you look at US GAAP forty or fifty years ago, you could probably argue it was principles-based,” said Finnegan. Does this mean that IFRS will go the way of US GAAP and become rule-based? “I don’t think so but the likelihood is that, with a lot more literature out there, the need for interpretation and guidance will grow.”

BG Group’s Gary Wilkes highlighted how “the oil and gas industry is coming under increasing pressure for greater transparency of reporting with developments such as the Dodd-Frank reform in the US, ‘publish what you pay’ developments and country by country reporting proposals.” Finnegan acknowledged the importance of such issues and pointed out that they are covered in part in a chapter in the IASB discussion paper on extractive industries. But he questioned their applicability to IFRS: “We’re primarily about developing standards for general purpose financial statements. I would question whether that sort of specialist information has a place in IFRS.”

Q&A

**What is your view on the convergence of the time line with the FASB on specific standards?**

**Patrick Finnegan, IASB board member:** I am cautiously optimistic that the two boards will find a way to finish the big four projects – leasing, revenue recognition, insurance and financial instruments - substantively by the end of 2012. By that, I mean we will have tackled and wrestled to the ground approaches to the thorny issues in those projects. I don’t think we’ll have published final standards for all four of them. It’s very possible we will have published the final standard on revenue recognition. Leasing has an outside chance as well, depending on when we get the new exposure draft out and the nature of the comments we will receive on that.

**What about the way the two boards work together more generally?**

**Patrick Finnegan:** When the boards debate issues separately, it can create this pattern of leapfrogging where one will debate an issue and the other one will come to that same issue and arrive at a different conclusion. Then each is always trying to play catch up. The pending decision that we’re all waiting on from the Securities and Exchange Commission will have important implications for the whole effort towards convergence. I’m an optimist. We may have differences but, looking ahead, I think the way the FASB interfaces with the IASB will be more along the lines of the way the model for national standard setters interface with the IASB.

**You talked about achieving a balance between new topics and maintenance. What, in your opinion, are the issues for which maintenance is required?**

**Patrick Finnegan:** Number one on the list in my mind are post implementation reviews. They’re like a report card on whether or not the objective laid out for a new standard is being delivered. I think also the role of the Interpretations Committee has to be made a little bit clearer.

**Michael Stewart, IASB Director of Implementation Activities:** I think there are some limited scope improvements that could address pre-existing inconsistencies in some of the standards or conflicts between standards. One that came to the Interpretations Committee recently was the conflict between what was SIC 13 and the requirement to only recognise partial gain on contribution to a joint arrangement versus the IFRS 10 approach of full gain recognition. That’s a conflict that the Board is already aware of and has said that it will address in the future. It’s things like that where I think we can improve consistency of application and clarity without causing significantly big changes to the standards.
Joint arrangements

The new IFRS 11 Joint Arrangements has significant implications for the oil and gas sector and also for many power and utility and mining companies. It becomes effective in 2013, although earlier application is allowed. The standard introduces a number of significant changes (see panel).

IASB board member Patrick Finnegan encouraged companies to engage with the Board in the interpretation and roll-out of the standard: “Other industries have not been bashful in coming forward and I’m sure we can find time on the Board’s agenda or the Interpretations Committee to talk about issues that you feel need clarification.”

Central to IFRS 11 is the issue of whether or not the parties, or a group of the parties, have joint control of the arrangement. If yes, it is a joint arrangement and IFRS 11 applies. It is then a question of whether it is structured through a separate vehicle. If it is not, it is a joint operation. If it is structured through a separate vehicle, it will be classified as a joint venture or a joint operation, depending on the terms of the arrangement and the other relevant facts and circumstances.

Mary Dolson, Partner, PwC UK, Global Accounting Consulting Services, pointed out that the changes will require companies to scrutinise their arrangements: “If an arrangement is promoted as a joint venture, you need to look at it quite carefully. When tested against the criteria, we’ve found a number that are not.”

Finnegan observed that the new standard “may require some changes to the way you conduct or structure future operations. A key question in determining the difference between a joint operation and a joint venture is ‘are the economic arrangements or the substance of the economic arrangements between the parties more or less the same, if you were to strip away the legal entity?’ If they wouldn’t be substantially different, that is a powerful argument for the use of joint operation and not joint venture accounting.”

The implications of IFRS caused some comment from roundtable participants. One observed: “With an IFRS 11 implementation date of 2013 and the need to have comparatives for earlier years, there isn’t a huge amount of time to delve into contracts and get it right.” Another pointed out that his company “could see some practical problems in collecting the comparative data, especially because we need to get data from joint venture partners who may not be anxious to supply the information.” Patrick Finnegan offered some reassurance: “I think the Board can be quite sympathetic to those situations. There is a world of difference between deferrals because of problems of information gathering and deferrals because companies just don’t like the answer.”

IFRS 11 – main changes

• ‘Joint arrangement’ replaces ‘joint venture’ as the new umbrella term to describe all arrangements where two or more parties have joint control.
• Unanimous consent is required over the ‘relevant activities’ in order for joint control to exist.
• There are two types of ‘joint arrangements’ – ‘joint operations’ and ‘joint ventures’.
• The legal form of the separate vehicle, the terms of the contractual arrangements and, when relevant, other facts and circumstance drive the categorisation of a joint arrangement as a joint operation or a joint venture.
• In a joint operation each venturer accounts for its share of assets, liabilities, revenues and expenses.
• In a joint venture each venturer accounts for the investment using the equity method.
• The policy choice of proportionate consolidation is eliminated.
Revenue recognition

In June 2011 the IASB and FASB agreed to re-expose their revised proposals for a common revenue recognition standard. The second exposure draft of their joint revenue proposals was imminent at the time of the roundtable. It will cover all types of revenue transactions except those specifically scoped out – leases, insurance contracts, certain financial instruments and non-monetary exchanges between entities in the same line of business designed to facilitate sales to customers.

The identification of whether or not distinct goods and services have transferred to a customer and the nature of performance obligations with the customer is central to the proposed standard. The issue of how to determine when goods and services are distinct was the subject of some debate and the Board hopes that the revised exposure draft will simplify this. Similarly, changes have been made to the guidance on when it is appropriate to combine contracts in circumstances when revenue is recognised over time.

IASB board member Patrick Finnegan commented: “I think an awful lot of judgment will go into this. We’ve decided to eliminate the requirement in the initial draft to segment performance obligations and we’ve revised the criteria around the allocation of the transaction price. I hope it will make the analysis a lot simpler.” There is also a significant change with the notion of incremental costs replacing the requirement to charge contract acquisition costs to expense. Other changes include the wording in warranties and cases where there is what is called ‘variable consideration’ in allocating the transaction price.

“\textbf{If you find the new model is accelerating your revenue, it is worth checking the way you are interpreting it.}”
**Leases**

The IASB’s project to develop a new single approach to lease accounting has been in progress for around seven years. Its goal is to ensure that all assets and liabilities arising under lease contracts are recognised in the balance sheet. At the time of the roundtable, a revised exposure draft was being prepared with publication imminent. The Board is getting fairly strong support for the ‘right of use’ model for lessees and the new exposure draft will have a ‘receivable and residual’ approach for lessors.

Some of the most heated debate has come from the lessor community on a possible discontinuity between the recognition of assets and liabilities. IASB board member Patrick Finnegan observed: “I think we recognised there is a problem in that respect and tried to look at various ideas for amortising the right of use asset and liability. But, at the end of the day, the Board concluded we needed to stay faithful to what we call an asset and our overall concept of how these things should be recognised in the P&L.”

**Leases – 2011 redeliberations**

<table>
<thead>
<tr>
<th>Exposure draft</th>
<th>Redeliberations</th>
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<tbody>
<tr>
<td><strong>Lease term</strong> (term options)</td>
<td>• Longest possible lease term more likely than not to occur.</td>
</tr>
<tr>
<td></td>
<td>• Reassessed.</td>
</tr>
<tr>
<td><strong>Variable lease payments</strong></td>
<td>• Included on probability-weighted basis.</td>
</tr>
<tr>
<td></td>
<td>• Reassessed.</td>
</tr>
<tr>
<td><strong>Short-term leases</strong> (lease term ≤ 12 months)</td>
<td>• Liability/asset recognised with no discounting.</td>
</tr>
<tr>
<td></td>
<td>• No liability/asset recognised.</td>
</tr>
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<td></td>
<td>• Rent expense.</td>
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Other changes are summarised in the chart. Finnegan commented: “Short term leases and variable leases, for the most part are excluded. The Board has set a fairly high hurdle for when you have to include a term option in the non-cancellable minimum lease payments. Variable lease payments are essentially excluded from the analysis. I think that was also pleasing to many people and so we’ll account for them as they are incurred.”
The IASB hedge accounting project is one of three initiatives to replace IAS 39. The other two – (1) classification and measurement and (2) amortised costs and impairment – are the subject of convergence discussions with the FASB. An exposure draft on hedge accounting was published in 2010 and much of 2011 has been spent on redeliberations.

The next step is likely to be a ‘staff draft’ for IASB website publication and further feedback. The ultimate objective is to incorporate it in IFRS 9 but the ‘when’ and ‘how’ of this remains uncertain and will, in part, depend on the outcome of discussions on impairment and classification of measurement. The Board is also examining macro hedge accounting. This is a topic on which there had been previous discussions which are set to be picked up and developed again over the course of the coming 12 months.

IASB board member Patrick Finnegan described the proposals in the new general hedge accounting standard as “far more permissible in terms of how hedge accounting can be used but with no less rigorous requirements when it comes to documentation and the way it has be applied and rolled out. In theory, by allowing entities to use risk management information as a basis for hedge accounting, we believe we’re going to produce more faithfully representative and useful information.”

The new proposals will also peel away the restrictions in IAS 39 on accounting for and hedging of group items. It will permit the combination of a non-derivative exposure with a derivative, calling that a hedged item and using a hedging instrument to hedge the aggregated exposure. Finnegan cited the example of a mining company selling a commodity and facing the foreign exchange risk that goes with it: “In this particular case the forex risk essentially represents that hedged exposure. In the past you would only have been able to select one of those and you wouldn’t be able to aggregate them.”

Finnegan singled out the guidance around hedge effectiveness and evaluation of hedge effectiveness as “probably the one area that I think has got a lot of attention and I think this is a question also where perception and reality may differ. The qualifying criteria for hedge accounting clearly have been modified to capture the core principle of trying to align risk management activities with hedge accounting. To that end, we’ve eliminated the ‘bright line’ test for eligibility. So that I think is good news to most of you.”

A key change is that IAS 39 allows components of financial items to be hedged, but not components of non-financial items. But risk managers often hedge the risk components of non-financial items, for example the oil price component of jet fuel. The exposure draft proposes to eliminate that distinction and introduce a principles-based approach in which the key test would be whether a risk component can be identified and measured as opposed to determining what can be hedged by type of item.
Hedge accounting

But Finnegans went on to emphasise the importance of the right documentation about hedging relationships and risk management strategy: “This would include appropriate documentation of what the hedging instruments are, what the hedged items are, the nature of the risks and how the entity will actually assess whether or not their hedging relationship meets the hedge effectiveness requirements. An analysis of the sources of ineffectiveness and how a hedge ratio would be determined are critical components of that documentation.”

A final observation made by Finnegans on the revised hedging draft concerned ‘rebalancing’. “The important point here is that when you do rebalancing, adjusting your hedge ratio in the light of data or information received in the marketplace, you do not necessarily have to discontinue the hedging relationship. You can continue and rebalance. It doesn’t mean you do not recognise any previous ineffectiveness. You’re always recognising ineffectiveness as it emerges but the key difference here is that you won’t have to discontinue.”

“We’ve eliminated the ‘bright line’ test for eligibility. So that I think is good news to most of you.”

General hedge accounting – 2011 deliberations

<table>
<thead>
<tr>
<th>Topic</th>
<th>Decision</th>
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<tbody>
<tr>
<td>Equity investments measured at fair value through OCI</td>
<td>• Agreed to allow hedge accounting.</td>
</tr>
<tr>
<td>Fair value hedge accounting mechanics</td>
<td>• Retain mechanics in IAS 39.</td>
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<tr>
<td></td>
<td>• Require single note about cash flow and fair value hedges.</td>
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<td></td>
<td>• Disclosure of fair value hedge adjustment.</td>
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<tr>
<td>Hedging of layers with prepayment options</td>
<td>• Can hedge:</td>
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<tr>
<td></td>
<td>– a layer component within the hedged item for the amounts that are not pre-payable</td>
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<td></td>
<td>– pre-payable layer if prepayment effect included in measurement of hedged item.</td>
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<tr>
<td>‘Own use’ scope exception</td>
<td>• Extend to contracts that meet the ‘own use’ scope exception the FVO in IFRS 9 if it eliminates or significantly reduces an accounting mismatch.</td>
</tr>
<tr>
<td>Accounting for forward points</td>
<td>• Permit forward points that exist at inception of the hedging relationship to be recognised in profit or loss over time on a rational basis.</td>
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<td></td>
<td>• Accumulate subsequent fair value changes in accumulated other comprehensive income.</td>
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<tr>
<td></td>
<td>This is to provide a better representation of the economic substance of the funding swap transaction and the performance of the net interest margin.</td>
</tr>
<tr>
<td>Disclosures</td>
<td>• Changed the disclosure requirements related to the amount, timing and uncertainty of future cash flows in the exposure draft. The Board tentatively decided to rather focus on the terms and conditions of the hedging instrument.</td>
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Can you say more about IFRS 10 and the question of when you consolidate and when you don’t in situations where you don’t have a majority of the voting rights?

Patrick Finnegan, IASB board member:
Look at your package of rights, the collective rights. What do they point to? Among other things, obviously, you’ve got to look at what other type of instruments you may hold other than just pure common stock. Do you hold options, and what is the nature of those options? I think you have to look at what has been your previous relationship. Also, is the product of the subsidiary essentially sold to the parent? It’s looking at the totality of the information and the relationship and asking yourself what’s the purpose of this holding.

When it comes to joint arrangements, many of these are established in limited liability companies to actually afford some legal protection to the participants. Is there not a danger of having to put liabilities inappropriately on the balance sheet if they are assessed as joint operations?

Michael Stewart, IASB director of implementation activities: Clearly the intention is not to start recognising the liabilities for which you do not have an obligation. I’d view the standard as requiring you to look really hard and carefully at what are the combined effects of both the legal structure that you have and your obligations under the contract – what the combination of those two together give rise to. If you don’t have an obligation, then I would struggle to see why you would be recognising a share of the liabilities in that situation.

Patrick Finnegan: I agree. I think another side of the issue is that you have to examine whether or not that third party entity can be pierced, not only economically, but legally.

Looking at 2011 year-end financial statements, what are the issues you would be looking out for both from existing standards and new ones coming out?

Mary Dolson, Partner, PwC UK, Global Accounting Consulting Services: We are continuing to get a lot of impairment questions coming up. Although up to now commodities have held up very well, volatility elsewhere and general concerns about the economic situation have led to impairment issues. Also, we’re getting a number of interesting questions of interpretation of IFRIC 4. Finally, revenue recognition policies. My personal test is can you read the revenue recognition policy and identify the industry in which the company works? Quite often, that’s not the case. These are just some of the issues.
**Extractive activities**

The sector has fairly unique accounting issues. At present *IFRS 6 Exploration for and Evaluation of Mineral Resources* governs accounting for extractive activities. But many observers feel the existing standard is not that helpful in promoting consistency or comparability as it tends to permit existing variable practice in different parts of the world.

A discussion paper was published by the IASB in Spring 2010 but the Board is yet to make a decision on whether the extractive activities project should be added to its active agenda. The goal would be to create a common approach to the recognition and measurement from disclosure of extractive activities for both oil and gas assets and minerals. Will it become a priority topic?

“Tackling the high-level issues will be important for success.”

The attempt to develop a more global approach has entailed a push away from theories of full cost or successful efforts, leading to resistance from the US oil and gas industry in particular. “We’re pleasing some people and displeasing others,” said Finnegan. “The attitude is ‘if it ain’t broken, why are you guys trying to fix it?’ But, as far as I’m concerned, it is broken because anything that can’t be used in a global arena is not going to help an investor make comparisons across borders.”

Cutting through the high-level conceptual issues at a global level is important for the success of the project. “If we tackle these issues before we start trying to push them down into projects, we’re more likely to have success, particularly if we get the buy-in of the key national standard-setting organisations. Otherwise we are setting ourselves up for another 10-15 year project and that does not make sense.”

There has been general support for getting some common definitions but, as always, the devil is in the detail. Asset definition, whether to use fair value or cost, and where to disclose in the accounts are all contentious issues.
One of the critical issues is whether to move forward with the historical cost measurement model or to use fair value. The latter has many subjective assumptions and estimates that limit its usefulness and comparability. The former is verifiable and less costly to prepare but has limited relevance to users. The discussion paper proposes measuring at historical cost but Finnegan emphasised that “you’ve got to think what information does an investor need? In terms of the practical question, I think the guidelines within IFRS 13 *Fair Value Measurement* are instructive in terms of the model we might use.”

Clearly the jury is out on this critical issue. Paul Morshuis, vice president accounting and reporting at Shell International, observed: “From our conversations with a number of investment banks, we didn’t get the impression they would be eager to move to fair value instead of historic cost. If you move to fair value, there are so many parameters on which people can have different views. There are volume and quality aspects, different gas prices in different markets and different perspectives on how these prices will develop over time, time curves, discount rates etc. In a nutshell, values as such will not be very meaningful due to lack of comparability”.

“Whether to move forward with the historical cost measurement model or to use fair value is a critical issue.”
Much of the discussion in the oil and gas sector breakout session was focused on joint arrangements and revenue recognition. There was a concern that the new joint arrangements standard could open up the possibility of oil and gas companies having to account for some upstream and midstream vehicles on the balance sheet: “The reason to set up these entities is to make them easier to operate and allow them to fundraise in their own name”, said PwC’s Mary Dolson. “Companies are equity accounting for these at the moment but an unexpected change is that some of those things may have to go on the balance sheet, meaning assets and quite often the significant debt that’s associated with them.”

Simon Ingall, Head of Group Accounting Policies R&D at Shell and a member of the Advisory Panel to the IASB research project team prior to the publication of the Extractive Activities’ Discussion Paper, added: “It’s a big issue if we now find that whether or not the partners take the output is a determining factor. We are generally dealing with a commodity which could be sold in the market and so selling to the partners is not the only available source of a venture’s cash flows.”

Ingall added: “There’s also the practical issue of partners to a venture taking 100% one year, zero then next, 40% the next year and so on. The implication is that they would have to hop back and forth between the two accounting treatments with the obvious question of how to deal with that.” The outcome may be a form of proportionate consolidation. Dolson smiled: “We’ve been trying not to call it ‘proportionate consolidation’ but it does look pretty much the same. It gives you gross revenue and gross expense.”

Turning to the IASB and FASB proposals for a common revenue recognition standard, the roundtable considered whether this may affect the accounting for underlift, volumetric production payments and production sharing arrangements in the oil and gas industry. The sector has raised some questions about these areas and the extent to which the revised exposure draft answers these questions remains to be seen.

Derek Carmichael, Senior Manager, PwC UK, Global Accounting Consulting Services, outlined circumstances when underlift could fall outside the revenue recognition standard: “Because of the definition of a ‘customer’, a company’s joint venture partners might not qualify. Even if you are able to determine there is a customer there, the proposals talk about non-monetary exchanges. Given that in an underlift situation you are essentially switching current for future shares of production, again you could come outside the standard.”
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This raises the issue of what the accounting would be. Carmichael outlined two possible approaches: “The first is a US GAAP-style sales approach where you don’t actually recognise a sale or revenue until you actually sell it to a third party. You wouldn’t recognise associated DTA either and you would also continue to recognise the reserves in your reserve disclosures until you sell it to the third party. This would represent quite a significant change from the current accounting approach.”

A second approach, even if you’re outside the scope of the revenue standard, is that you may still have a receivable from your collaborators under IAS 39 if there’s a net settlement component to the production sharing agreement. This raises the question, if you’re going to recognise a receivable, where would you put the credit? Would you put it against cost of sales? Against other income? Or you might still actually be able to disclose it as revenue if you’ve concluded that it’s still been generated in the ordinary course of your activities and it meets the conceptual framework definition of being revenue.

IASB board member Patrick Finnegan said it was a relevant matter for the Board to consider. “If you are coming up with an outcome that is significantly different and is accelerating or decelerating revenue, then it would be very helpful to understand what element or aspect of the model that you’re giving emphasis to that is having that effect. These are the kind of things I would suggest aggregating and bringing to the Board in an industry forum as we’ve done with the software industry, telcos and certain other specialised industries.”

Given the difficulties of putting fair value into financial statements, do you think the extractive industries project is more likely to go down a disclosure rather than a measurement route?

Patrick Finnegan, IASB board member: That has been raised as a possibility. If you are not going to recognise and measure reserves, then why not at least provide disclosure. I am strongly in favour of at least disclosing the values of proven reserves with discussion of the assumptions that are underlying that disclosure. Then I can make comparisons between companies and draw my own conclusions about the credibility of management assumptions.

Do you think that users are vocal enough in the standard-setting process?

Patrick Finnegan: I think the level of participation in standard setting has to be higher from the investment community. It’s tough to get people to participate. They don’t write comment letters so we have to go out and meet with them, talk to them, engage with them.
Sector spotlight

**Power and utilities**

The power and utilities breakout session focused on hedge accounting as well as leases and power purchase agreements. It also heard from the IASB’s Michael Stewart on the Board’s ongoing consideration of whether IFRSs should be amended to improve reporting of rate-regulated activities.

Konstantin Suplatov observed: “Accounting shouldn’t be dictating what the business should be doing. But, what I see in many companies is that the traders are kept away from discussion about the impact of IAS 39s when, in fact, they need to be aware of and involved in that. There are some trade-off decisions that companies have to make around who should be sitting in the driver’s seat. To put it bluntly the original standard wasn’t written with physical commodities to the fore.”

Moving on to leasing, the power and utilities breakout group examined the proposed revisions to the standard on leases, particularly their effect on power purchase agreements. Ralph Welter, Senior Manager, PwC Germany, Member of Global Power & Utilities IFRS Group, pointed to “significant changes for the better.” The changes are summarised in the accompanying chart.

Finally, the breakout session got an update from IASB director of implementation activities Michael Stewart on the Board’s rate-regulated activities project. The comment period on the initial exposure draft ended in November 2009 with the Board’s proposals getting a divided response. There was extremely strong support from the North American utility industry but mixed support from the rest of the world.

Board discussions in 2010 focused on issues such as whether regulatory assets and liabilities exist, if they should be recognised in accordance with the framework and whether recognition of regulatory assets and liabilities is consistent with other standards. The Board is itself divided in its views and the next step is to decide if rate-regulated activities should be part of the future board agenda. Stewart emphasised that the utility industry’s viewpoint on this will be very important: “If you think that regulatory activities is a subject that the Board should address, then do tell us. Your response will have an impact on the Board’s decisions as to whether to add it to its agenda.”

On the hedge accounting front, the discussion focused on some of the changes outlined in the ‘hot topics’ section of this report. It also highlighted the importance of breaking down silos within organisations to improve cross-functional understanding of the requirements. Konstantin Suplatov, PwC Director, Corporate Treasury Solutions, pointed out: “It’s not enough just to understand the accounting rule. Companies need to make sure that the whole business works together and understands the risk appetite of the Board and the ultimate objective of risk management strategy. In order to get your hedge accounting right, all the stakeholders should be managed and advised properly.”

There was some discussion of whether there is a danger of the accounting rules overburdening the risk management. One participant involved in trading activity within a utilities company put it in stark terms: “You either do the hedging that you would want to do to manage your economic risk and then you fall out of bed from hedge accounting or you stay in bed with hedge accounting and you pay the economic penalty for not being able to hedge in the most effective way. There are ways in which our trading business would want to manage hedging, particularly through the use of dynamic hedging strategies, that cannot be made to comply with the documentation requirements of hedge accounting.”
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<th>Q&amp;A</th>
<th>From the utilities sector point of view and looking at the discrepancies in how rate regulation has been accounted for in the US part of the world compared to elsewhere, do you see convergence coming along in this issue?</th>
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<td>Michael Stewart, IASB director of implementation activities:</td>
<td>Yes, I do see that as being an important area that the Board should put onto its agenda early on and address because for me there’s nothing worse than uncertainty. I think that a fair bit of uncertainty has built up about whether you can or cannot recognise regulatory assets and regulatory liabilities. My personal view is that it would be helpful if the Board provided an answer to that question, or to at least provide the tools to be able to answer that clearly.</td>
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<td>Pat Finnegan, IASB board member:</td>
<td>Yes, I’m eager to solve the problems for that sector as well. But I would add that if we can solve some other fundamental points of principle then finishing the standard on regulation becomes much easier.</td>
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<td>Can you explain a little bit further the changes in the own use exemption under IFRS 9?</td>
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<td>Konstantin Suplatov, PwC Director, Corporate Treasury Solutions:</td>
<td>Sure. Under current IAS 39, own use or accrual accounting for contracts was mandatory if the contract was entered into solely for the purpose of the physical supply of the business. Under the revised draft, even if it meets the criteria of own use, companies will be able to fair value the physical commodity contract if it is managed on a fair value basis within the trading business unit. From a trading entity perspective, one of the ways to spare efforts on hedge accounting is typically how management evaluates its business. It should be pointed out that a different accounting view could be taken from a trading business unit and a consolidated group perspective, and the revised draft gives you flexibility.</td>
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There was no previous specific guidance on stripping costs under IFRS. The new interpretation seeks to bring consistency to reporting in this area in contrast to the diversity of practice under current accounting regimes. In US GAAP, for example, these costs are accounted for as a variable production cost. In Canadian GAAP this is also the case unless betterment is identified, in which case they are capitalised. In addition to these North American approaches, many companies are using strip ratios and, included in these, life of mine stripping ratios.

IFRIC 20 focuses on surface not underground mines and is limited to the production phase not the development phase. There is much more consistency of accounting practice for the development phase, with companies typically capitalising development costs. The interpretation does not cover pre-production stripping or oil sands extraction but Michael Stewart, the IASB’s director of implementation activities, emphasised that it “is neutral in terms of the natural resource that is being extracted so, for example, it would apply equally to coal mining as well as ore minerals.”

IFRIC 20’s measurement of the asset follows a cost-based approach, based on the directly incurred costs plus the allocation of attributable overheads. But, with two benefits arising from a single activity, there has to be a basis for measuring the two components. Stewart explained that the committee decided that some form of production measure should be used – for example a ratio of costs, quantity of ore or mineral content.

The new interpretation starts with the viewpoint that there are two potential benefits from stripping activity – the production of usable ore, which is accounted for as inventory under IAS2, and a second benefit of improved access to ore that can be mined in the future. Stewart outlined that “this benefit should be recognised as an asset and that companies will need to identify the component of the ore body for which access will be improved.”

This component of the ore body will form the stripping activity asset for both capitalisation and amortisation or depreciation purposes. “Depending on how you describe your various mining properties or mines in your financial statements, you would identify an appropriate place to put that,” said Stewart. He added: “What the committee stopped short of was to try and determine if it is a tangible or an intangible asset. If it’s part of an existing asset, then it ought to follow the same classification as that existing asset.”

“Joint arrangements is a big issue for the mining industry. There are a lot of stakeholders and communicating any changes in reporting needs to be carefully thought through.”
Financial reporting in the oil & gas, power & utilities and mining sectors

The exact choice of measure is left to individual companies to identify. But Stewart emphasised: “The one thing they shouldn’t do is to use sales values because sales values are not closely enough linked to the actual activity. The activity that’s taking place here is all about mining some material and improving access to future material. It’s not about selling the material itself.” Similarly, for depreciation, the units of production method is mentioned but not prescribed in the interpretation. “I would expect pretty much all companies to be using this method but the committee didn’t want to rule out any other methods if there are circumstances in which they are more appropriate,” said Stewart.

After IFRIC 20 the mining breakout discussion turned to IFRS 11 Joint Arrangements. Joint arrangements are already an important feature of the mining sector. And they are likely to increase in importance with developments such as vertical integration and increased activity by sovereign wealth funds and state-funded enterprises in the sector. PwC’s Jon Lambert, a partner in the UK mining practice, observed: “It’s a big issue for the industry. There are a lot of stakeholders and communicating any changes in reporting needs to be carefully thought through.”

We’re at the beginning of a mine. If you have an expectation that there will be overwork plus additional stripping during production, can you make provision for it and capitalise and depreciate it from the beginning or do you wait until you actually encounter it?

Michael Stewart, IASB director of implementation activities: You wouldn’t be able to provide in advance for costs not incurred because, typically, you wouldn’t have an obligation to incur those costs, at least not a legal obligation. You might have a commercial obligation but that would be the extent of it. So, yes, it would be a case of recording the costs as they come through. The costs that get capitalised are actual costs incurred.

Have you got a feel for how much change IFRIC 20 will entail for mining companies?

Jason Burkitt, UK Mining Leader, PwC: In the discussions we’ve had, those using the life of mine model might not see too much of a difference in debit and credit terms initially, but the work to get there is going to change drastically.

Q&A

This is one of those standards where the devil is in the detail and you’re going to need to involve the geologists to take it forward. There are very few nice egg-shaped ore bodies out there these days and the calculations can be quite hard. In some cases, you may need to make a judgement as it may not be worth doing really detailed calculations for a small amount of betterment. It is potentially quite a lot of change to your processes and work at the mine level.

What about multiple pits. What are the circumstances when these can be combined?

Michael Stewart: The focus here is intended to be on the ore body. If you’re accessing the same part of the ore via two different pits, then I can see an argument for saying it’s one component of the ore body and, therefore, look at it together. But, if you are not really talking about one continuous area and work on one pit isn’t going to give you access to the ore that’s being accessed from the other pit, then I don’t see a basis for combining the two.
Some of the big messages emerging from the roundtable:

1. Don’t keep your experience to yourself - the coming period will bring considerable IFRS change and the success of the new standards will be better if there is feedback given by companies.

2. Act now – with some 2013 implementation dates and the need for earlier comparatives, there isn’t a huge amount of time to get things right for the new standards on consolidation and joint arrangements.

3. Be ready to look ahead at the implications of the new joint arrangements standard for the way you conduct or structure future operations.

4. Look hard at the substance of the current economic arrangements and contracts between parties in the light of the new standard on joint arrangements.

5. Think through the communications implications of any changes in joint arrangements reporting in the light of the multiple stakeholders involved.

6. If the new revenue recognition model seems to be significantly accelerating or decelerating your revenue, it is worth checking the way you are interpreting it.

7. Look ahead to whether the proposals for a common revenue recognition standard may particularly affect the way you account for underlift, volumetric production payments and production sharing arrangements.

8. IFRIC 20 could entail a lot of detailed work for mining companies with surface stripping operations – be ready to involve the geologists where necessary as well as the accountants.

9. IFRS may be set to be more permissible in the way hedge accounting can be used but remember to make sure your trading operation is managed and advised properly about the reporting requirements.

10. The jury is still out on many of the big conceptual principles that will dictate the future IFRS as well as the detail – the experience of the oil and gas, power and utilities and mining sector will be very valuable in that debate.