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A golden moment for mining

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Mining, despite its status as a globally important industry, has received little specific attention over the years from standard setters. Developments at the IASB and IFRIC may end that obscurity and bring major changes in a wild ride for miners. The IFRIC is working on guidance for production stripping costs, and the IASB is expected to issue a discussion paper on extractive activities in early 2010. These projects, together with a couple of others nearing completion at the IASB, could have a big impact on many IFRS reporters in the mining sector.

The other projects at the IASB that may bring change to mining entities are new standards on provisions and joint ventures. This article outlines the expected changes in accounting for provisions and explains the potential impact on decommissioning obligations. The publication of the joint arrangements standard will mean the end of proportionate consolidation for many entities and will be key to structuring new cooperative working arrangements.

IFRIC adds 'stripping' to its agenda

Stripping is a crucial issue in mining but possibly less exciting than it sounds. Mining is about taking minerals out of the ground at a reasonable cost. Moving waste material and 'overburden' to recover the ore is known as 'stripping'. A key statistic for a mining company is its 'stripping ratio' for each mine. A stripping ratio of 3:1 means that, over the life of a mine, the entity will have to move three tons of waste to extract one ton of ore. Costs associated with overburden and waste removal during the development phase of a mine are capitalised and then amortised once production begins. Waste removal, to some degree, almost always continues during the production phase. Treatment of the related costs during production presents more challenges.

There is no specific guidance under IFRS on how to account for production stripping costs, and the IFRIC has acknowledged that diversity exists in practice. A decision was made at the November 2009 meeting to work towards an interpretation on the issue.

Broadly speaking four different methods of accounting for production stripping are used in practice, as described below. There are further variations of these methods, but most mining entities would follow one of the approaches described.

1. Expense production stripping costs as incurred

Stripping costs are expensed as incurred where the stripping ratio is expected to be relatively constant over the life of the mine and the mining method only requires removal of overburden shortly before extraction of the ore.

2. Capitalise stripping costs as cost of inventory

Production stripping costs are considered variable production costs that should be included in the costs of the inventory produced (that is, extracted) during the period that the stripping costs are incurred. This approach is consistent with US GAAP and one of the alternatives accepted under Canadian GAAP.

3. Capitalise stripping costs and attribute to reserves benefited in a systematic and rational manner

Production stripping cost may fluctuate significantly from period to period due to different reasons (for example, variations in the thickness of the layer of overburden, the physical properties of the ore body and operational requirements). Entities defer production stripping costs that do not relate to the ore production of the period. If the activity contributes to the betterment of the mineral property, production stripping costs are capitalised. The costs are subsequently allocated and amortised upon extraction of the ore. This method is one of the two accepted under Canadian GAAP.

4. Capitalise stripping costs using a strip ratio

This approach requires the current period ratio of overburden/mineral ore extracted to be compared with the expected average over the life of the mine. This method relies on good estimates of the average ratio based on the feasibility studies of the project. Higher-than-average stripping costs are deferred when the actual strip ratio exceeds the average expected strip ratio. Deferred stripping costs are expensed in the opposite situation. This approach is used by many under IFRS.

The IFRIC session in November 2009 included a lengthy 'educational' session to help IFRIC members understand the industry and the accounting issues. The project plan for the proposed interpretation was agreed at the January 2010 meeting; and the staff hopes to have a final interpretation by the end of 2010. The scope for the interpretation was agreed as: *'Accounting for the costs of removal of waste material in a surface mining activity during the production phase'*.

Where is IFRIC expected to go?

Early indications from the debate at IFRIC are pointing towards one of the current Canadian approaches: capitalise production stripping costs when they represent 'betterment' (alternative 3 above). This is seen as consistent with the Framework definition of an asset. This approach may make economic sense; conversely, it appears to be the least popular among entities, possibly because it requires the most accounting effort and requires considerable judgement to determine if there has been a 'betterment'.

Additional income statement volatility for some entities may be one of the consequences if this approach is adopted. Entities currently expensing or including stripping as an inventory cost would be most affected.

A number of related issues were discussed by the IFRIC. These will be addressed in the March 2010 meeting. Some the concerns are:

- Amortisation: guidance on amortisation of the deferred costs would be needed if the interpretation requires or permits deferral of production stripping costs.
- Definition of production phase: a definition of the production phase will be necessary.
- Surface mining versus underground mining: the interpretation is driven largely by concerns arising from surface mining. However, some entities with deep mines might want to analogise the interpretation for costs incurred in an underground mine in a production period.
- Future economic benefits: inclusion of a 'future economic benefits' test might have a significant effect on the scope of the interpretation. Limiting the scope to only those stripping costs associated with future benefits might not cover those stripping costs that do not result in betterment.

The IFRIC has not addressed some of the other issues inherent in stripping, such as dealing with multiple pits and push-backs. Many mining entities are keen for these matters to also be considered to ensure that there is a thorough airing of the issues, consistency of application and ultimately understanding by users of the impact of stripping activities.

Extractive activities project

The current IFRIC debate focuses on a narrow area of accounting for mining entities. However, a team of national standard setters and the IASB are engaged in a project that could change the face of accounting for upstream oil and gas and mining. It has published a draft discussion paper (DDP), 'Extractive activities'.

The DDP is called a 'working draft'. The IASB has not yet debated the preliminary conclusions and questions, and there is no formal request for comment at this stage. However, the IASB is expected to debate the DDP and issue it as a due process document in the first quarter of 2010. Comments are likely to be due in the third quarter of 2010, after which the IASB would make a decision on taking the project forward to a standard.

The DDP's focus is the financial reporting issues associated with mineral reserves and resources. The key question is whether and how to define, recognise, measure and disclose reserves and resources in the financial statements. It does not address

many of the other accounting issues that challenge the industry, such as commodity contracts, joint working arrangements, stripping, revenue recognition and decommissioning and restoration activities.

The DDP proposes working towards a single IFRS for oil & gas and mining industries, using industry definitions of reserves and resources. The project team recommends using the SPE and CRIRSCO reserves and resources definitions[1] as a reference point for developing a financial reporting model. Other key proposals in the DDP are:

- Mineral assets are recognised when a legal right to explore is acquired. Information gained from exploration and evaluation activities, as well as development activities, represent enhancement of the exploration/reserves & resources asset.
- The unit of account is initially the geographical area of the exploration right. This is refined over time as exploration and development plans are developed, ultimately resulting in one or more units of account, generally at the level of the individual mine.
- The components approach used for property, plant and equipment is applicable for the components of a mineral asset.
- Mineral and oil & gas assets are measured at historical cost, supplemented by disclosure of volume and current value of reserves. The views of users and cost benefit concerns heavily influenced this conclusion.
- Detailed disclosures in the financial statements of:
  - Reserve quantities, by commodity, and by country or project (where material).
  - Either current value or fair value measurement of proved and probable reserves, by major geographical region.
  - Production revenues by commodity.
  - Costs, disaggregated in the same way as reserve quantities, with a five-year track record of exploration, development and production costs.

The DDP also considers the proposals from the Publish What You Pay (PWYP) campaign. PWYP is a coalition of non-governmental organisations campaigning for mandatory disclosure of company payments and government revenues from the oil, gas and mining sector. The project team has suggested further study to see if additional disclosures meet the cost-benefit test.

Potential changes in accounting for decommissioning and restoration

An ED on IAS 37 published last month proposes potentially significant changes to the measurement of decommissioning and restoration liabilities (see the main edition of *IFRS news*, February 2010, p1). It proposes that an obligation such as asset decommissioning will be measured based on the amounts that the entity would rationally pay a contractor to undertake the service on its behalf. Current practice among mining entities is to measure these obligations on the basis of ‘least cost to exit’ or what it would cost the entity to carry out the decommissioning in the future

The revised proposals are likely to result in an immediate increase to the provisions recognised on the balance sheets of mining entities today, together with an increase in the related assets (where costs can be included as an element of property, plant and equipment under IAS 16). Borrowing costs will increase and the increased provisions unwind; mining entities may need to gather more information from external parties and consider multiple scenarios or methods of remediation to comply with a new standard.

The IASB originally exposed changes to IAS 37 in 2005. It has continued to debate aspects of the provisions standard and decided to issue a narrow ED addressing only the measurement aspects of the standard. Discussions at the IASB have confirmed the other key change to provisions accounting: removal of the ‘probability’ threshold for recognition of provisions. IAS 37 has been applied in practice as requiring the recognition of an obligation when the outflow of economic benefits was ‘probable’, usually interpreted as having a more than 50% chance of occurring. This will change under the new standard to ‘expected’, and the recognition threshold will disappear.

Mining entities often cause disturbance to the environment during mine development and mining operations. The costs of rectification are often significant and include costs for dismantlement, demolition of infrastructure, remediation of environmental damage and removal of residual material.

The related obligations are recorded when the damage is caused. Provisions are recorded when there has been an event that results in the probable outflow of economic benefits. Most provisions today are measured as the net present value of the estimated future costs to rehabilitate/restore the disturbance to date. The estimation of costs will include both external expenditure and internal costs essential to the closure.

The measurement approach proposed in the current ED may well result in a change in the measurement of all provisions, including decommissioning and restoration obligations. The IASB considers that estimates of a third-party contractor price would be more objective evidence of the value of an obligation than the entity’s own cost to fulfil the same obligation. Implicit in the use of a ‘market’ price for a contractor is the inclusion of direct and indirect costs and profit margin that a contractor would require. This price is likely to be higher than the entity’s own cost to perform a similar service. The new measurement criteria in the ED might result in a potentially significant increase in decommissioning obligations. It might also result have the odd result of the recognition of income in the future when the obligation is extinguished and the entity compares its actual restoration/dismantling costs (presumably lower than market rates) against the liability recorded.

[1] The Oil and Gas Reserves Committee of the Society of Petroleum Engineers (SPE) and the Committee for Mineral Reserves International Reporting Standards (CRIRSCO) have completed a high-level mapping of the equivalency of the 2007 SPE and the 2006 CRIRSCO reserves and resources classifications.

The comment period for the ED closes on 12 April 2010. Interested parties are encouraged to submit comments.

Potential impact of ED 9, 'Joint arrangements'

The IASB has been working on a replacement standard for IAS 31, 'Joint ventures', for several years. ED 9, 'Joint arrangements', was exposed for comment in September 2007. The key proposals in the ED are expected to appear in the new standard.

The main change proposed by ED 9 is a change in how joint arrangements are classified. Entities may have an interest in a joint asset, joint operation or joint venture. Classification will be based on the contractual rights and obligations of the parties under the arrangement rather than the legal form of the arrangement as under IAS 31. Joint operations, under the proposals, would include both joint operations and joint assets. These would be joint working arrangements where the parties directly own the assets or a share of the assets and take a share of the output. Each party would account for its own assets and activity, resembling the current accounting for joint assets and joint operations in IAS 31.

An arrangement whereby the parties have joint control and an interest in the net outcome of the joint arrangement will be described as a joint venture. Equity accounting will be required for joint ventures, and proportionate consolidation will be eliminated as an accounting method.

The ED is also expected to include guidance for joint arrangements that include both joint assets/operations and a joint venture. Net profit royalty arrangements are common in mining and share many of the economic characteristics of joint ventures, and there is some diversity in accounting practice. It is unclear if these will be in the scope of the final standard.

A new standard – incorporating SIC-13, 'Jointly controlled entities non-monetary contributions by venturers' – is expected during the first quarter of 2010. The standard is expected to have a mandatory implementation date of 2013. This seems like plenty of time, but management of mining entities should be looking at their current joint arrangements today to see if structural changes are necessary and possible to maintain their preferred accounting. New joint arrangements should be established considering the new guidance.

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